

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable

Item 2. Changes in Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits.

27.1 Financial data schedule

(b) Reports on Form 8-K.

The Company filed a Current Report on Form 8-K dated October 22, 1999 to report under Item 5 the acquisition of substantially all of the assets of 9 Net Avenue, Inc. for approximately \$51.8 million and the assumption of approximately \$9.9 million of liabilities.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 15, 1999

CONCENTRIC NETWORK CORPORATION

By: /s/ Henry R. Nothhaft

Henry R. Nothhaft,
President, Chief Executive
Officer and Director

By: /s/ Michael F. Anthofer

Michael F. Anthofer,
Senior Vice President and
Chief Financial Officer

<ARTICLE> 5
 <MULTIPLIER> 1,000

	3-MOS	9-MOS
<PERIOD-TYPE>		
<FISCAL-YEAR-END>	DEC-31-1999	DECJ I - 1999
<PERIOD-START>	JUL-01-1999	JAN-01-1999
<PERIOD-END>	SEP-30-1999	SEP-30-1999
<CASH>	225,791	225,791
<SECURITIES>	70,396	70,396
<RECEIVABLES>	20,553	20,553
<ALLOWANCES>	864	864
<INVENTORY>	0	0
<CURRENT-ASSETS2>	324,438	324,438
<PP&E>	134,452	334,452
<DEPRECIATION>	60,525	60,525
<TOTAL-ASSETS>	456,728	456,728
<CURRENT-LIABILITIES>	52,808	52,808
<BONDS>	0	0
<PREFERRED-MANDATORY>	212,595	212,595
<PREFERRED>	0	0
<COMMON>	363,684	363,684
<OTHER-SE>	(324,981)	(324,981)
<TOTAL-LIABILITY-AND-EQUITY>	456,728	456,728
<SALES>	38,082	101,175
<TOTAL-REVENUES>	38,082	101,175
<CGS>	34,711	93,894
<TOTAL-COSTS>	56,255	153,896
<OTHER-EXPENSES>	0	0
<LOSS-PROVISION>	0	0
<INTEREST-EXPENSE>	1,920	7,775
<INCOME-PRETAX>	(27,208)	(78,926)
<INCOME-TAX>		
<INCOME-CONTINUING>	(27,208;	(78,926;
<DISCONTINUED>	0	0
<EXTRAORDINARY>	0	0
<CHANGES>		
<NET-INCOME>	(27,208;	(78,926;
<EPS-BASIC>	(.65)	(2.03)
<EPS-DILUTED>	(.65)	(2.03)

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K/A

FOR ANNUAL AND TRANSITIONAL REPORTS PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

☐ Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended: December 31, 1998

OR

☐ Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission file number: O-22575

CONCENTRIC NETWORK CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

65-0257497

(I.R.S. Employer
Identification No.)

1400 **Parkmoor** Avenue, San Jose, CA

(Address of principal executive office)

951263429

(zip code)

Registrant's telephone number, including area code: (408) 817-2800

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

None

Name of each exchange on which registered

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, 50.001 par value

(Title of Class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☐

No ☒ ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in **definitive** proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ☐.

The aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the closing sale price of the Common Stock on January 29, 1999 as reported on the National Market of The Nasdaq Stock Market, was approximately **\$408,584,320.50**. Shares of Common Stock held by each officer and director and by each person who owns 5% or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes. As of January 29, 1999, registrant had outstanding **15,981,314** shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

The Registrant has incorporated by reference into Part III of this Form 10-K portions of its Proxy Statement for Registrant's Annual Meeting of Stockholders to be held May 19, 1999.

The Business section and other parts of this Report contain forward-looking statements that involve risks and uncertainties. The Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations—Factors Affecting Operating Results" commencing on page 32.

PART I

ITEM 1. BUSINESS

BUSINESS

Concentric provides tailored, value-added IP-based network services for enterprises and consumers. To provide these services, the Company utilizes its **low/fixed** latency, high-throughput network, employing its advanced network architecture and the Internet. Concentric's service offerings for enterprises include VPNs, DAFs, DSL, remote access and Web hosting. These services enable **enterprises** to take advantage of standard Internet tools such as browsers and high-performance servers for customized data communications within an enterprise and between an enterprise and its suppliers, partners and customers. These services combine the cost advantages, nationwide access and standard protocols of public networks with the customization, high performance, reliability and security of private networks. Among the current enterprise customers are Intuit, SBC, Teligent and WebTV. Concentric's service offerings for consumers and small office/home office customers include local Internet dial-up access, DSL, and applications hosting.

The Company was incorporated in Florida in 1991 under the name Engineered Video Concepts, Inc., changed its name to Concentric Research Corporation in 1992 and commenced network operations in 1994. In 1995, the Company changed its name to Concentric Network Corporation and reincorporated into Delaware in 1991.

Industry Background

Development of Private Networks

Historically, the data communications services **offered** by public carriers had limited security features, were expensive and did not adequately ensure accurate and reliable transmission. As a result, many corporations established and maintained their own private WANs to provide network-based services, such as transaction processing, **to** their customers and to coordinate **operations** between employees, suppliers and business partners. Such private WANs were frequently customized to specific applications, business practices and user communities. As a result, these private WANs had the capability of **providing organizations** and users with tailored performance and features, security, reliability and private-label branding.

The demand for WANs has grown as a result of today's competitive business environment. Factors stimulating the higher demand include the need to provide broader and more responsive customer service, to operate faster and more effectively between operating units, suppliers and other business partners, and the need to take advantage of new business opportunities for **network-based** offerings in a timely fashion. In addition, as businesses become more global in nature, the ability to access business information across the enterprise has become a competitive necessity.

Despite the attractive capabilities of private networks, limitations of many private WANs have impeded or reduced the effectiveness of their use. These networks, which traditionally have required the use of leased telephone lines with bandwidth dedicated solely to this purpose and the purchase of vendor-specific **networking** equipment, **are** inherently expensive to set up, operate and maintain. Private WANs often require the development and maintenance of proprietary software and lack cost-effective access. These aspects of developing, deploying and maintaining such private WANs have conflicted with the increased focus of many businesses on their core competencies, which has prompted the outsourcing of many non-core functions. The Company believes that many businesses have viewed as

unacceptable the costs of maintaining a private WAN **infrastructure** and the risks of investing in new technologies in the absence of a single technological standard.

Emergence of the Internet

The emergence of the Internet and the widespread adoption of IP as a data transmission standard in the 1990s, combined with deregulation of the telecommunications industry and advances in telecommunications technology have significantly increased the attractiveness of providing data communication applications **and** services over public networks. At the same time, growth in **client/server** computing, multimedia personal computers and online computing **services** and the proliferation of networking technologies have resulted in a large and growing group of people who **are** accustomed to using networked computers for a variety of purposes, including **email**, electronic file **transfers**, online computing and electronic **financial** transactions. These trends have led businesses increasingly to explore **opportunities** to provide IP-based applications and services within their organization, and to customers **and** business **partners** outside the enterprise.

Need for IP-Based Private Networks

The ubiquitous nature and relatively low cost of the Internet have resulted in its widespread usage for **certain** applications, most notably Web access and **email**. **However**, **usage** of the Internet for mission-critical business applications has been impeded by the limited security and unreliable **performance** inherent in the **structure and** management of the Internet. On the Internet, latency is frequently relatively **high** and variable, making it sub-optimal for these emerging applications. Although private networks are capable of offering lower and more stable latency levels, providers of **these** emerging applications also desire a network that will offer their customers full access to the Internet. As a result, these businesses and applications providers require a network **that** combines the best **features of** the Internet, such as openness, ease of access and low cost made possible by the IP standard, with the advantages of a private network, such as high security, **low/fixed** latency and customized features.

Industry analysts expect the market size for both value-added IP data networking services and Internet access to grow rapidly as businesses and consumers increase their use of the Internet, inwnets and privately managed IP networks. According to industry analyst Forester Research, Inc., the total market for these services is projected to grow from \$6.2 billion in 1997 to approximately \$49.7 billion in the year 2002, with approximately \$27.9 billion in the enterprise market segment and \$21.8 billion in the consumer market segment.

The Concentric Solution

Concentric provides tailored, value-added IP-based network services for businesses and consumers using a low/fixed latency, high-throughput network. Concentric allows enterprises to create virtual private networks providing tailored network access, content and services to **enterprise-defined** end users with higher reliability **and** more security than is available over the Internet. Concentric's VPN solutions also provide the ease of access and flexibility of public networks at a lower cost than private WANs without sacrificing reliability or security.

The Concentric network employs an advanced, geographically dispersed ATM and **frame** relay backbone, SuperPOPs in 19 major metropolitan areas and 143 secondary and tertiary POPs in other cities. The Company's architecture allows most customers in the U.S. and Canada to access its network through a local telephone call. In addition to dial-up access, the Company provides **frame** relay, DSL, fractional T-1, T-1 and DS3 access to the network. The Concentric network is engineered and managed to provide superior quality of service, balancing several key performance criteria. The Company provides guaranteed levels of service for dedicated access facilities to enterprise customers, and targets performance benchmarks for connection **success** rates, latency levels **and** throughput for all of its service offerings.

Business Strategy

The Company's objective is to become the leading supplier of value-added, IP-based network services worldwide. In order to achieve this goal, the Company is implementing a business strategy focused on the following key principles:

Rapidly Provide Cost-Effective, Tailored Network Solutions. The Company intends to capitalize on its expertise in developing **tailored VPNs** to establish a leadership position **in** rapidly developing, deploying and maintaining a range of value-added network services to meet the specific needs of its customers. The Company utilizes a set of software **and** hardware technology modules as "building blocks" to offer a variety of tailored network services on **an** IP-based network architecture with minimal additional **investment** in engineering and rapid time to market for businesses and consumers. These building blocks include modules for client and system **software**, dedicated and remote network connectivity, tracking **and** billing, Web hosting, customer support and security.

Optimize Network Utilization. Given the **fixed** cost **nature** of Concentric's network **infrastructure**, the Company strives **to increase** total network utilization and to optimize this utilization by targeting both daytime business and evening-intensive consumer users to balance the **network's** usage throughout a 24-hour period. Accordingly, while the Company's current strategic focus is on providing value-added IP-based communications services to enterprises, the Company intends to continue partnering with multi-channel distributors to acquire **and** maintain a base of consumer subscribers who access the Concentric network **predominantly** during non-business hours.

Acquire Complementary Assets, Technologies and Businesses. The Company is actively seeking to identify and acquire assets, technologies and businesses complementary to the Company's value-added enterprise network service strategy. Such acquisition efforts are targeted at businesses that offer the potential to expand the Company's revenue base, increase the scalability of the Company's network **infrastructure** and value-added service offerings, as well as optimize the utilization **of the** Company's network. As part of this strategy, the Company completed three acquisitions in 1998. The Company acquired **InterNex**, a Tier 1 provider of network services, colocation service **and** Web-hosting facilities to enterprise customers, in February 1998. The Company acquired **Deltanet**, a provider of network services, colocation and managed dedicated hosting services, in May 1998. The Company acquired **AnaServe**, a provider of shared hosting and managed dedicated hosting services, in August 1998.

Employ Leveraged Marketing Through Strategic Partners. The Company actively seeks to form alliances with certain software developers and telecommunications service and equipment suppliers that have substantially greater marketing, distribution and sales resources than does the Company and that have a large installed customer base. These alliances facilitate the cost-effective acquisition of consumer and business customers **and** increase Concentric's network utilization. These marketing relationships are developed and enhanced through the bundling **of** Concentric's IP-based network services with the products and services offered by the strategic **partners**. These relationships may involve customized browsers, registration services and specialized pricing, commissions and billing programs. To date, Concentric has established such strategic relationships with a number of companies, including WebTV, SBC, Williams, Covad, Teligent, Intuit, **Nortel/Bay Networks, Inc.** and TMI.

Deploy Network Services Internationally. The Company believes that its enterprise customers increasingly will require their network solutions providers to offer network services on **a global** basis. To date, the Company has launched the following initiatives to provide global solutions to its **customers**:

Mondonet. Pursuant to an agreement with TMI, entered into in August 1996, the Company is working to establish an international network based on Concentric's network technology and expertise and TMI's existing telecommunications **infrastructure**. The goal is to deliver a range of compatible network services worldwide. TMI currently has a telecommunications network deployed in 40 countries worldwide. In April 1998, the Company and TMI launched **Mondonet**, the **first** international network designed and built expressly to support VPN services with coverage in more than 30 cities in 24 countries.

Roaming Services in Japan. The Company entered into a roaming services agreement in June 1997 with NTT PC, a leading provider of **IP** services in Japan. The roaming services agreement allows Concentric customers to use the NTT PC network to access their Internet **accounts** in Japan and allows members of the NTT PC network to access their Internet accounts in **the** United States and Canada.

GRIC Roaming Alliance. **The** Company executed a roaming services agreement with GRIC International in October 1998. GRIC International is **an** alliance of 400 **ISPs** and telecommunication companies that together form a worldwide network of 2,700 **POPs**. The GRIC International alliance allows **the** Company's **customers** to access the Internet through **these** worldwide **POPs** while traveling outside of the United States.

Hosting Services in the United Kingdom. The Company entered into a strategic agreement with GX Networks, one of the largest **ISPs** located **in** the United Kingdom, in August 1998. The agreement allows GX Networks and the Company to expand Web **hosting and extranet** services for each other's customers. Through this agreement, the Company **can** serve the networking needs of its domestic United States customers based in the United Kingdom.

Global Web Hosting Facilities. The Company acquired Web hosting facilities in Stockholm, Sweden, Tokyo, Japan and Hong Kong in **February** 1998 as **part** of the acquisition of **InterNex**.

While the Company does not expect to generate significant revenue from deployment of international network services until at least the year 2000, the Company believes that the ability to deliver network solutions globally will be a key competitive factor in its industry. The foregoing expectation is a forward-looking statement that involves risks and uncertainties and the **actual** results could vary materially as a result of a number of factors including those set **forth** in "Management's Discussion and Analysis of Financial Condition and Results of Operations-Factors Affecting Operating Results-We Face Risks Associated with International Expansion."

Services

Concentric provides tailored, value-added **IP-based** network services for businesses and consumers. To provide these services, the Company employs a **low/fixed** latency high-throughput network based on **an** advanced, geographically dispersed ATM and frame relay backbone and the Internet.

Enterprise Solutions

The Company has developed a set of enterprise services including **VPNs**, dedicated access facilities, digital subscriber line services, wireless **access** services and applications hosting services. These services are marketed to Concentric's enterprise customers.

Virtual Private Network Services. Concentric's custom VPN solutions enable its customers to deploy tailored, **IP-based** mission-critical business applications for internal enterprise, business-to-business and **business-to-customer** data communications on the Concentric network while also affording high-speed access to the Internet. Concentric offers its customers a secure network on which to communicate and access information between an organization's geographically dispersed locations; collaborate with external groups or individuals, including customers, suppliers, and other business **partners** and use the Web to access information on the Internet **and** communicate with other Web users.

The Company's VPN solutions allow the enterprise customer to tailor the type of access, services and information that various users **of the** VPN are afforded according to the specific needs of the enterprise. Key benefits include rapid implementation time, lower operating and maintenance costs, minimal capital investment, higher quality of service overall and **24-hour** network and customer support. For example, starting in October 1995 the Company created and now maintains the VPN used by Intuit customers using a customized version of the **Netscape** Navigator browser bundled with Quicken for Windows and 'Macintosh, Quickbooks, **ProTax** and

TurboTax/MacInTax. The bundled software allows a Quicken customer to click on an icon that launches Netscape, and takes the user directly to Quicken Financial Network **Website**. On the Web page Quicken customers will find useful financial advice, information from Intuit's bank and financial institution **partners**, answers to commonly asked technical questions and tips on how to tap the full potential of Intuit's financial products.

In addition to the custom **VPNs** that Concentric has developed and delivered, the following **three** distinct VPN products are now offered by the Company:

Concentric CustomLink. Concentric **CustomLink** provides a complete, private-labeled dial-up VPN service for customers. In addition, **CustomLink** permits the **customer** to segment its users, and apply various levels of services, such as Web access, **email**, and file transfer protocol to each customer group. **CustomLink** includes dial-up network access, customized and customer-branded client **software**, and private labeled help desk services. The dial-up network access offerings include local access, **toll-free** access, and a unique connection service, **PremierConnect**, which provides such subscribers with connectivity to the VPN, even if local access numbers are busy.

Enterprise VPN. The Company's Enterprise VPN service includes security hardware and software, high speed network access, network connectivity, customer **premise** routing equipment and customer support services. The Enterprise VPN **service** is targeted at customers seeking to create a secure, **outsourced** WAN for intranet and **extranet** applications. Installation support for the customer premise located routing and security equipment is also provided. Concentric can also provide management services for **firewall** and packet encryption equipment if desired by the customer.

Concentric RemoteLink. The Company's remote access service is targeted at businesses that have employees in remote locations. **RemoteLink** offers customers the potential to significantly reduce the high costs of telecommunications charges and user support associated with building, deploying, and maintaining an internal remote access **infrastructure**. **RemoteLink** enables an enterprise's salespeople and other mobile employees, **telecommuters** and business **partners** to dial into an enterprise's corporate network resources and use them as if they were connected locally, thus increasing potential productivity and allowing for information to be available on a real-time basis across the enterprise. Concentric's **RemoteLink** is designed to be highly customizable and provides the ability to interface with existing company network **infrastructure**.

Concentric performs around-the-clock monitoring of **network** performance. Concentric also enables its customers to monitor their network through the Company's proprietary **ConcentricView** software. **ConcentricView** is a Web-based network management tool which allows a customer to monitor usage on a call-by-call basis and performance of that portion of the Concentric **network** bandwidth supporting the customer's applications.

Dedicated Access Facilities. In January 1997, the Company began offering **DAFs** as a stand-alone product targeted at businesses that desire single or multipoint high-speed, dial-up and/or dedicated connections to distributed locations such as regional offices, warehouses, manufacturing facilities and/or to the Internet. DAF products **are** primarily **targeted at** providing **intranet** connectivity among distributed enterprise **locations** with the additional benefit of Internet access if desired by the customer. The Company provides a **full** range of connectivity options, allowing the customer to order the appropriate amount of bandwidth to meet its networking requirements. In addition, Concentric offers its DAF customers a guarantee on the quality of service and performance of these facilities. Furthermore, Concentric believes it is the only network service provider to bill customers based on average usage levels rather than peak usage **levels**.

Concentric has six offerings in its dedicated access product line: **FullChannel** T-1, **FullChannel** T-1 Protected, **FlexChannel** and **LECFrame** Relay, as well as **FullChannel** and **FlexChannel** offerings at DS3 bandwidth options which support up to 45 Mbps. The Company has begun working with key customers to support even higher speeds up to OC3 (155 Mbps).

FullChannel T-1 and DS3 pricing is based on a one time set-up fee and average utilization pricing. The customer's usage is measured at five-minute intervals throughout the **month**, and the average of all of those

measurements is used to determine the customer's bill at the end of the month. The one time set-up fee for **FullChannel** T-1 service is \$3,000 and the monthly fee ranges from \$1,095 to \$2,695 depending on usage. The one time set-up fee for **FullChannel** DS3 service is \$5,000 and the monthly fee ranges from \$6,000 to \$40,500 depending on usage. **FullChannel** T-1 and DS3 pricing is the appropriate choice for those customers who have fluctuating and/or uncertain bandwidth consumption patterns.

FullChannel T-1 Protected gives a customer a **fixed** price for a full 1.5 megabits of bandwidth. The one time set-up **fee** is \$3,000 and the monthly fee is set at \$2,095. This is an economical choice for those customers **who** recognize in advance that their bandwidth throughput requirements will equal T-1 levels.

FlexChannel gives a customer the **opportunity** to purchase a fractional portion of a T-1 or DS3 for a **fixed** monthly fee. The set up fee is the same as for **FullChannel** pricing but the monthly fee ranges from \$895 to \$1,895 for **FlexChannel** T-1 service and from \$5,900 to \$40,500 for **FlexChannel** DS3 pricing. **FlexChannel** T-1 and DS3 pricing is the appropriate choice for the customers who know that their bandwidth requirements are going to be consistently less than a full T-1 or DS3.

LECFrame Relay is based on various **LECs'** Frame Relay facilities. Although Concentric does not **offer** service level guarantees over LECFrame Relay, Concentric does guarantee the **committed** information rate. This offering gives a lower cost, lower performance network service for those customers for whom **performance** is less imperative. Concentric charges a one time set-up fee of \$2,000 LECFrame Relay services and monthly fees ranging from \$395 to \$1,195 depending on usage.

Digital Subscriber Lines. In December 1997, Concentric began offering Internet and **intranet** connectivity using DSL technology. DSL and its variants are a new dedicated access technology being deployed by telephone companies that allow high speed digital **service** over regular telephone lines. To expand its DSL service area, the Company has formed relationships with a number of **CLECs**, including **Covad** Communications Group, Inc. and **NorthPoint** Communications, Inc., as well as **SBC's** California subsidiary, Pacific Bell. Concentric's DSL service offerings are currently available in the following geographical markets: the San Francisco Bay Area, Los Angeles, San Diego, Boston, New York, Washington, D.C., and Chicago. Several additional markets are planned during 1999. The Company's DSL service offerings include a wide range of dedicated access speeds, from 144 Kbps to 1.5 Mbps symmetric DSL, as well as 1.5 Mbps/384 Kbps asymmetric DSL.

Concentric DSL services are targeted at the small-to-medium sized business, **telecommuter** and consumer markets. The "dedicated access feature" of DSL services combined with its high speed **and** low flat rate pricing **are** designed to appeal to the large installed base of **ISDN** users. Pricing for the service is low **relative to** traditional dedicated access services, making it attractive to medium sized businesses, while at the same time broadening the market to reach small businesses who previously could not justify the expense of dedicated Internet service.

Pricing is based on the bandwidth of the DSL circuit, and is a flat rate monthly fee ranging from \$149 to \$499 depending on the service speed. Concentric provides complete installation services including all the customer premise equipment necessary to provide the DSL service at fees ranging from \$325 to \$725.

Wireless Access Services. In October 1998, the Company introduced **ConcentricWireless** as an alternative to traditional access lines, **particularly** in areas where DSL is not yet available, **ConcentricWireless** has a unique distribution system that provides sustained speeds up to 1.5 Mbps and is priced competitively with **ISDN** and DSL services and significantly lower than T-1 services. At speeds ranging **from** 512 Kbps to 1.5 Mbps, **ConcentricWireless** provides high-speed personal Internet connectivity for the small business, small **office/home** office or telecommuting consumer. **ConcentricWireless** is currently available in the greater San Francisco Bay Area at prices ranging from \$150 per month for 384 Kbps symmetric to \$450 per month for 1.5 Mbps/152 Kbps.

Applications Hosting Services. The Company offers a range of high-performance applications hosting services, including Concentric **Server** Solutions, a suite of sophisticated high-end hosting and Web site **traffic management** solutions for Internet-centric businesses, and **ConcentricHost**, a suite of Web hosting, e-commerce, and **streamed** media services designed for small to medium-sized businesses. The Company's other applications hosting **services**

include a private-label version of **ConcentricHost** and a Windows NT-based hosting solution. The high performance of the Company's applications hosting services is enabled by Concentric's network architecture and its combination of public and private peering arrangements.

Together, these applications hosting services manage a company's Web-based **infrastructure** and operational needs allowing customers to focus on their Web-based content. By outsourcing its Web hosting to Concentric, an enterprise can increase the reliability and **performance** of its Web applications and reduce its costs by taking advantage of Concentric's high quality data centers with back-up power, multiple high bandwidth network connections and Tier 1 Internet peering arrangements. In addition to state-of-the-art hosting facilities, Concentric provides server management tools and services to completely manage customers' servers for them.

For reliable, high **performance** flow of **traffic** between customer's Web servers and worldwide networks, Concentric has combined public peering and private peering arrangements to provide improved performance to users. Concentric currently operates data centers in Santa Clara, Cupertino, and Los Angeles, California, Chicago, Illinois and Washington, DC. A new 10,000 square foot data center in San Jose is scheduled to open in February 1999. Each Concentric data center is connected via multiple DS3 (45 Mbps) or OC3 (155 Mbps) high-speed links to geographically dispersed points in its private ATM backbone as well as to key public and private **Internet** exchange points. This **architecture** provides diversity and redundancy and high performance to customers while minimizing user costs. See "The Concentric Network."

Concentric Server Solutions Concentric announced the availability of Concentric Server Solutions, a line of Web hosting services **designed** for companies who require **outsourced maintenance**, management, bandwidth and housing for their Internet or **extranet** Web servers. Unlike **colocation** services that simply provide rack space in a data center and bandwidth, Concentric Server Solutions provide high-performance Internet access **from** state-of-the-art data centers, skilled technicians and systems administrators, maintenance programs that monitor servers 24 hours a day, seven days a week, and scalability to address the needs of companies as their businesses become increasingly reliant on the Web. The Company recently announced the following **two** enhancements to Concentric Server Solutions:

Distributed Server Environment. In September 1998, Concentric launched the Distributed Server Environment ("DSE") platform designed to manage distributed applications for content, media and Web-centric businesses. These businesses typically require high availability, fault tolerance and scalability for distributed hosted sites. DSE offers **local** and global load balancing and fail-over services. Load balancing allows for the intelligent distribution of user requests over multiple server resources to avoid transmission congestion and bottlenecks among Web servers.

Concentric Peak Protection. In December 1998, the Company introduced Concentric Peak Protection which offers "capacity on demand" or "peak insurance" for customers who need data center and network diversity and the ability to add Web site bandwidth **capacity on-demand**. Content providers, for example, can use Concentric Peak Protection to prepare for rapid growth and spikes in Web site **traffic** without making large up-front hardware and bandwidth **investments** ahead of demand. Concentric Peak Protection manages Web-site traffic spikes by **seamlessly** dividing traffic between Concentric hosting centers and other server locations. Concentric Peak Protection is ideal for companies that do not want to rely exclusively on a single hosting provider, ISP or their own data center for hosting and data center services.

Concentric Server Solutions, including Distributed Server Environment and Concentric Peak Protection range in price from \$550 to \$10,000 per month, depending upon the volume of **traffic** and number of customer servers required.

ConcentricHost. **ConcentricHost** is a suite of Web-hosting products and services designed to provide comprehensive solutions to the Internet needs of a small to medium-sized business in one account. Packages, which include Web hosting, multiple **email** IDs and dial-up Internet access range from \$29.95 to \$199.95 per month depending on the number of **email** accounts and the amount of disk space and bandwidth provided to the customer. These packages also offer shared security for e-commerce and are managed from a user-friendly Web interface. Other

features include access to 24 hours a day, seven days a week toll **free** telephone and **email** based customer support and built-in self administration tools that allow the customer to buy more features online in real time as well as to analyze Web activity online **in** near real time. The system automatically notifies **customers** when they are approaching the allocation limits of their account encouraging them to upgrade online.

In June 1998, Concentric enhanced **ConcentricHost** with the introduction of the Virtual Development Environment ("VDE"), which provides Web developers high level security and **performance** on the **ConcentricHost** shared server hosting platform. At the same time, VDE offers maximum **freedom** to Web developers by providing them with their own virtually dedicated operating and file systems. These virtually dedicated systems provide Web developers the freedom to create complex CGI scripts without security and stability risks and without requiring them to be reviewed and approved prior to installation.

ConcentricHost Private Label In November 1998, Concentric launched a private label hosting solution targeted at companies looking to quickly and cost-effectively add fully featured Web hosting to their small business service portfolio. The **ConcentricHost** Private Label solution allows service providers, small business retailers, and other resellers to leverage Concentric's proven technology in applications hosting with their own resources. This approach allows customers to avoid much of the time, equipment expense, and **information** services resources required to internally develop a Web hosting service.

Windows NT Hosting. The Company also has a line of Windows NT-based hosting and e-commerce services targeted at small to medium sized businesses. Concentric also **offers** Windows NT-based hosting services with its Concentric Small Business **Server Internet** Suite service which includes Web hosting, Internet **email** exchange and Internet access services designed to be used with Microsoft's Small Business Server.

Consumer Services

Concentric provides its individual and small office/home office customers with a broad range of Internet access options and Web hosting **email**, chat, file transfer protocol, Gopher and online shareware services. Users can choose from local and long distance direct dial **800-number** and telnet services. Concentric offers the Microsoft Internet Explorer to its users when they sign up for dial-up or **800-number** service.

Internet Access Pricing

<u>Plan</u>	<u>Monthly Fee</u>	<u>Additional Time</u>
S t a r t e r P l a n	\$ 1.95	\$1.95/hour after 5 hours
Standard Plan	\$ 19.95	No charges for additional time. Unlimited active access for one monthly fee.
800-number P l a n	\$ 10.00	\$5/hour after 2 hours
Inbound Internet Plan	\$ 10.00	No charges for additional time. Unlimited active access for one monthly fee.

The Company also offers consumers value-added services, including a collection of premium products targeted to vertical segments such as the family and small **office/home** office market. This includes the upselling of discounted products and services in such areas as retail products, **software**, hardware, telephony services with such partners as Amazon.com, Inc., QuadraCom, LLC, TuneUp.com, Connected OnLine Backup and Excite. Such arrangements not only provide an additional monthly revenue stream but also increase customer satisfaction **and** retention. Additional value-added products and services being reviewed by the Company for potential introduction include premium service, customer support, education research, **virus** protection, and faxing services,

Customers

The following is a representative list of the Company's customers during the last 12 months, each of which accounted for more than \$10,000 in revenues.

Acer America Corporation	Olin Corporation
Allegiance Telecom, Inc.	OnCommand Corporation
Amdahl Corp.	OzeMail Interline Pty, Ltd.
American Greetings Corporation	Peapod L.P.
Ameritech Corporation	Philips Mobile Computing
Andersen Consulting	PictureTel Corporation
AT&T Corp.	Pierce Leahy Corp.
Bay Networks, Inc.	PointCast Incorporated
Bloomberg, L.P.	Qwest Communications Corporation
Citizens Communications, L.P.	Redback Networks, Inc.
Corel Corporation	Rockwell International Corporation
Electric SchoolHouse LLC	SBC Communications Inc.
First USA, Inc.	Sega of America, Incorporated
Graybar Electric Company, Inc.	Teligent, Inc.
Hitachi Metals America, Ltd.	The Vanguard Group, Inc.
Intuit Inc.	3Com Corporation
Iomega Corporation	TMI Telemedia International, Ltd.
Juno Online Services, L.P.	U.S. Office Products Company
Kleiner, Perkins Cautield, & Byers	USWeb Corporation
MCI WorldCom Inc.	Wawa 1°C.
Microsoft Corporation	WebTV Networks , Inc.
Netpulse Communications, Inc.	Williams Communications Inc.
Netscape Communications Corporation	You Bet! On-Line Entertainment
Network Associates Inc.	Ziff-Davis Publishing Co.
NTT PC Communications, Inc.	

Revenue from WebTV accounted for 26.8% of the Company's revenue during the year ended December 31, 1998 and 33.4% of the Company's revenue during the year ended December 31, 1997.

Strategic Business Alliances

The Company aggressively pursues strategic business alliances with a variety of companies. Through these partners, the Company seeks to expand its enterprise and consumer customer base and increase the 24 hour utilization of the Concentric network. The following is a summary of selected strategic relationships:

WebTV Networks Inc. WebTV provides the world's **first** high-quality Internet solution for television. In the fall of 1996, WebTV's licensees, Sony Electronics, Inc. and Philips Electronics introduced a plug-and-play set-top box that enables Internet browsing from a television. As **part of the** WebTV service, Concentric and WebTV jointly designed and implemented a national virtual private dial-up network solution to connect WebTV **Network™** users to the Internet, utilizing Concentric's **network**. The WebTV Internet terminal, combined with the virtual private network, allows anyone to browse the Internet **from** the comfort of their living room.

SBC Communications Inc. In October 1998, SBC and the Company agreed to integrate **Concentric's Internet-**based business data services and technology into **SBC's** portfolio of data products and services for business customers. Concentric and SBC plan to deploy a complete suite of packet-switched, IP-based services such as VPNs, Web hosting, shared **software** and electronic **commerce** for business customers. SBC is working with

Concentric to design **and** offer a new product called Online Office. Targeted at medium **and** small businesses, Online Office is being designed to **offer** turnkey data solutions for businesses **that** want the benefits of data networking enjoyed by larger companies but lack the skill, time and resources to handle it themselves. Online Office is being designed to provide customers with local area network equipment, installation and network management services and network-hosted business applications. Applications include desktop office applications, **email**, calendaring and e-commerce. Online Office will also support more experienced businesses as they expand their data networking capabilities to include features like Web hosting, **intranet** and **extranet** services, electronic commerce and remote access. SBC **and** Concentric will host the services **and** software on **remote** servers and deliver the capabilities directly to the customers' desktops. SBC's Southwestern Bell **and** Pacific Bell units will provide the local telecommunications link between a customer's location and Concentric's network POP customers and Concentric will provide **inter**LATA long distance transport. SBC and Concentric have introduced these new services on a trial basis in San Francisco, California and Austin, Texas. Widespread deployment of portions of Online Office is planned for the second quarter of 1999. The entire Online Office package is targeted for release in the third quarter of 1999.

As part of this relationship, SBC agreed in October 1998 to acquire 906,679 shares of Concentric's common stock either on the open market or from the Company. In December 1998, SBC purchased 100,000 shares of common stock in two open market purchases. The remaining 806,679 shares were purchased from the Company in January 1999 for an aggregate purchase price of approximately \$19.5 million. We also issued SBC a warrant to purchase 906,619 shares of Concentric common stock at an exercise price of \$21.00 per share.

Williams Communications Group, Inc. Concurrent with the closing of the Company's initial public offering of common stock in August 1997, the Company entered into a strategic relationship with Williams Communications Group, Inc., a subsidiary of the Williams Companies, Inc. (together, "Williams"). Williams provides a full range of enterprise network solutions, communications services and advanced applications to businesses, including equipment and services for data, voice **and** video, international satellite and fiber-optic transmission services, telemarketing services, and multipoint video- and audio-conferencing. As part of the strategic business relationship, Williams has made available, and the Company has agreed to purchase from Williams, a total of \$21.2 million in telecommunications equipment and services through the five year period ending in 2002. At the election of Williams, \$2.0 million of the minimum purchase commitment may be paid by the issuance of Common Stock by the Company at the then-current fair market value. Additionally, Williams and the Company have entered into a reseller agreement and an agency agreement through which Williams is able to sell the Company's products and services for an initial term of two years. The agreements with Williams provide that, in the event of a change of control of the Company, Williams will have a right to purchase a nonexclusive, perpetual, license to use, distribute and modify all of the intellectual property of the Company, including any copyright, patent, license, trademark or trade secret which the Company has or obtains the right to transfer.

The relationship with Williams includes an equity investment in the Company by Williams of approximately \$15.0 million which closed in August 1997.

Covad. In January 1999, the Company entered into a strategic relationship **with** Covad to combine Concentric's value-added IP services with Covad's high speed DSL local loop services. This strategic relationship allows Concentric to resell Covad's DSL local loop services to Concentric's customers. The companies also **will** co-market DSL in approximately 20 major metropolitan areas in the United States and jointly **fund** product development efforts in 1999 and 2000. Additionally, Concentric invested approximately \$10.0 million in Covad, purchasing 555,556 shares of Covad's common stock at the initial public offering price of \$18.00 per share.

Teligent. Concentric signed an agreement with Teligent, a wireless CLEC, in February 1998 to provide nationwide backbone data network services. Concentric's services enable Teligent to **offer** a full range of high quality, high-bandwidth communication services to small and medium-sized businesses, **Teligent's** digital wireless networks interconnect with Concentric's ATM backbone to deliver high speed, Internet-based services in several dozen metropolitan markets throughout the United States. These services were launched in July 1998. **Teligent** plans to ultimately offer services in 74 major markets across the country and to interconnect with **Concentric** for data services in each of these markets. In addition, the agreement enables Teligent to **re-sell** Concentric's VPN **and** Web

hosting services through its nationwide sales team. **Teligent's** sales force began reselling selected Concentric products and services in August 1998.

Intuit. Intuit, a financial **software** and Web-based services company, is a market leader in personal and small business financial **software**. Intuit views its **Websites** as a key channel for communicating with its customers, and as a vehicle to provide personal **finance**, investment and tax related **financial** information. Concentric and **Intuit** **partnered** in October 1995 to launch integrated Internet access to the Quicken Financial Network and the Internet. The Internet access capability included both a **virtual** private network service designed to provide **Intuit** customers subsidized access to select **Intuit** Web sites and the ability to upgrade to **full** access to the Internet. **Intuit** has bundled tailored versions of the **Netscape** Navigator browser in its **fiscal** year 1998 and 1999 releases and the Microsoft Explorer browser in its 1998 and 1999 releases of **Quicken**, **TurboTax**, **ProTax** and **Quickbooks**. Concentric designed and implemented tailored registration and network access **software** to provide Intuit customers with seamless, subsidized access to select **Intuit** Web sites. Concentric provides an easy, Web-based **upgrade** process for customers desiring full Internet access and **email** services. Customers are billed for network time through Concentric's billing systems. In addition, Concentric provides private-labeled customer service to **Intuit** customers with full network access on a twenty-four hour a day, seven day a week basis. Intuit uses Concentric's high performance network primarily to enable customers to send electronic tax filings and **software** product registration.

Nortel/Bay Networks. In October 1997, Concentric began providing **RemoteLink** dial-up access service to **Nortel/Bay** Network's entire U.S.-based mobile **workforce**. **Nortel/Bay** Network's **RemoteLink** users dial into Concentric Network's high-performance network and are then "**tunneled**" through one of two secure T-1 connections to access their corporate **intranet**, never touching the Internet. A component of the service is that **Nortel/Bay** Networks controls authentication of the users permitted to access its corporate **intranet**. In addition, **Nortel/Bay** Networks uses Concentric's customer service center to provide round-the-clock user support. This **outsourced** solution has allowed **Nortel/Bay** Networks to realize considerable cost savings over traditional toll-free remote access and in-house help desk support services.

TMI. In August 1996, the Company entered into an agreement with **TMI** to establish an international network based on Concentric's network technology and expertise and **TMI's** existing telecommunications infrastructure. **TMI** currently has a telecommunications network deployed in 40 countries worldwide. In April 1998, the Company and **TMI** launched Mondonet, the first international network designed and built expressly to support VPN services with coverage in more than 30 cities in 24 countries. As part of the agreement with **TMI**, the Company granted **TMI** certain exclusive rights in certain critical markets, including Europe. **While** the goal of this effort is to deliver a range of compatible network services worldwide, only limited deployment of services has occurred under this agreement to date. The Company's experience in working with **TMI** to develop versions of its products and to market and distribute its products internationally is limited. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Factors Affecting Operating Results-We Face Risks Associated with International Expansion."

The Concentric Network

The Concentric network employs an advanced, geographically dispersed ATM and **frame** relay backbone, SuperPOPs in 19 major metropolitan areas plus a total of 143 secondary and tertiary **POPs** in other cities, allowing local dial-up access to the network to users in the U.S. and Canada. In addition, the Company can provide analog dial-up, frame relay, fractional T-1, T-1 and DS3 access to the network. Concentric is in the process of deploying 56.6 Kbps modems throughout its network and expects this deployment to be completed in the first quarter of 1999. This planned deployment is a forward looking statement and is subject to a number of risks and uncertainties and the **actual** results could differ materially as a result of a number of factors including those set forth under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations-Factors Affecting Operating Results-We Depend Upon New and Enhanced Services" and "Management's Discussion and Analysis of Financial Condition and Results of Operations-Factors Affecting Operating Results-We Depend Upon Our Network Infrastructure."

The Concentric network is managed via a centralized network control center in St. Louis, Missouri. Two data centers (located in Chicago, Illinois and Cupertino, California) house the servers that support log on/authentication, billing, **email**, Internet access, Web services and other network services. The Cupertino data center will be consolidated into the new San Jose, California headquarters building in mid-1999. In February 1998, the Company acquired **InterNex**, a provider of network services, **colocation** services and Web-hosting facilities to enterprise customers. With the acquisition of **InterNex**, the Company expanded its Internet connectivity strategy to include not only private transit with MCI, Sprint and **UUNet**, but also private peering with other network providers as well as public peering with multiple smaller Internet service providers. The Company's new hybrid private/public Internet connectivity strategy is designed to allow Concentric to offer superior Internet connectivity performance by avoiding congestion (packet loss) that may occur when connecting to certain network providers at many public **peering** points.

The Concentric **SuperPOPs** are designed to support both dial-up and dedicated access services within a broad geographic region. Typically, a **SuperPOP** will utilize one or more **CLECs** and **LECs** to aggregate dial **traffic** within a 50-200 mile radius of the **SuperPOP** and terminate it at the **SuperPOP**. This strategy allows Concentric to **offer** users local call coverage within the **SuperPOP** region without having to deploy individual **POPs** in each local calling area. All the calls are terminated at the modem equipment at the regional **SuperPOP**. This results in broader call coverage, lower costs due to the typically lower rates from **CLECs** and economies of scale from larger modem installations, lower maintenance costs, and easier capacity upgrades since equipment is located in a single location within a region.

DAFs and **DSLs** from customer locations in a region are terminated in the **SuperPOP** as well. Typically, Fractional T-1, T-1, and DS3 circuits are terminated directly **into SuperPOP** router equipment or via a **channelized** DS3 connected to a competitive access provider. Frame access is terminated via aggregated LEC Frame Access circuit(s). DSL is terminated via a multiplexed DS3 connection to a CLEC metropolitan **area** DSL network. Both dial-up and dedicated **traffic** is then aggregated by the routers/switches in the **SuperPOP** and directed to the Concentric ATM backbone via one or more DS3 ATM links.

The Concentric network also offers its customers the security, reliability and management features that companies require in their own private networks. Varying layers of security and encryption are supported and tailored to specific customer requirements. The network design includes a standard security layer and is compatible with most types of custom security applications. Further, security is provided at both the edge of the network and internally based on embedded **firewall** and encryption techniques. The Concentric network features **colocation of** network access and switching equipment in "hardened" facilities, direct connections to **carrier** facilities, a resilient ATM/frame relay backbone, dual data processing centers, and redundancy within data centers to substantially enhance its uptime performance.

Network managers, customer service and technical support **staff** require near real-time access to information about the performance and quality of their networks. In traditional private networks, this information is provided by network management, trouble reporting/tracking, and management information systems. **Customers usually sacrifice** a great deal of control and have access to less information when using a public network instead of a private network. It has been difficult for public network providers to provide their major customers with information regarding network performance that relates to that customer's usage without either compromising **other** customers' proprietary information or compromising the integrity of the **network** itself. Concentric has developed a set of **non-intrusive** software tools and reporting mechanisms, distributed to enterprise customers to allow a customer's network manager to monitor network **performance** and quality and to adequately support inquiries for help **from** their users. Web browsers and file transfer tools **are** used to provide access to much of this information. In **some cases**, custom integration of Concentric's network management and trouble tracking/reporting systems will be provided to customers.

Sales and Marketing

The Company focuses on marketing its services to two distinct market segments: enterprises (primarily small and medium size businesses) and consumers. By attracting enterprise customers who use the network primarily during the daytime, and consumer customers **who** use the **network** primarily at night, the Company is able to utilize its network infrastructure more cost effectively. The Company pursues these customers through a multi-tiered sales **strategy** consisting of leveraged third party distribution channels, inbound and outbound t&sales, value-added resellers, original equipment manufacturers and a direct sales force. As of December 31, 1998, **the** Company employed **168** persons in sales and marketing.

Leveraged Third Party Distribution. The Company has positioned itself as a key network services provider for companies that bundle network access in their products or services. For example, the Company's network service is bundled with Intuit's Quicken, **TurboTax** and Quickbooks products, Microsoft Office 98 and with WebTV's Internet access devices. Additionally, the Company is one of the Internet services providers listed on the Netscape Navigator and Microsoft Internet Explorer browser registration servers.

Telesales. The Company employs separate **telesales** groups to generate inbound leads in three market sectors. The consumer **telesales** group sells Internet connectivity and shared hosting to the consumer market. The Company's **AnaServe** sales group is focused on both shared and dedicated hosting and **electronic commerce** solutions for the small business sector. The inside enterprise sales group **offers** business solutions including T-1, DSL and wireless connectivity products as well as shared and dedicated hosting products to enterprise customers. In addition, **an** outbound group is dedicated **to** generating leads for field sales and resellers, **as well as managing** the customer installed base in the pursuit of upgrades and contract renewals.

Value-Added Resellers. The Company has established sales channels and significant market coverage through value-added resellers without incurring the commensurate costs of a large direct sales force. These resellers are categorized into four groups, national and regional network integrators and **colocation** and shared hosting resellers. In the enterprise market, these companies sell both network equipment and full service network/Internet solutions, including design, installation and maintenance. Williams Communications Solutions is a national network integrator with over 300 trained sales and support professionals who **are** compensated for selling Concentric's enterprise connectivity, VPN and dedicated hosting solutions. Concentric solicits shared hosting developers and resellers through a combination of on line advertising and direct t&sales, and currently has over 500 resellers in this market. In addition, the Company has launched a trial program with Microsoft for the sale of the Microsoft Small Business Server bundled with Concentric DSL for sale through the Microsoft Value Added Provider channel.

OEM Sales. Concentric recently adopted an OEM, i.e. private-label, strategy that enables national telecommunications infrastructure providers to offer a full suite of private labeled **IP-based** consumer and enterprise network services. Concentric's OEM partners, such as Teligent and SBC, sell Concentric's services through their large sales forces into established customer bases.

Direct Sales Force. The Company employs 29 field sales people located in San Jose, Orange County and Los Angeles, California, Dallas, Texas, Washington, D.C., the New York metropolitan area, Atlanta, Georgia, Chicago, Illinois and Boston, Massachusetts for support of complex custom enterprise VPN solutions and to acquire, support, train and retain distribution channel partners. The Company's field sales **force** is supported by inside sales/account managers, project and program managers and systems engineers.

Concentric markets its **enterprise** services to marketing and information service professionals, enabling companies to take full advantage of IP-based WAN, intranet and **extranet** applications. The Company uses print advertising in targeted industry publications, end-user seminars and media spot advertisements specifically to build awareness and acquire leads for its **VARs** and its direct sales team.

In the consumer market, the Company focuses on direct mail to targeted audiences; establishment of customer referral programs; and co-marketing such as packaging literature with Mastercard mailers and **Intuit software**. In addition, the Company has implemented online customer retention programs, such as a **Website** "home" where they can learn how to use the service, how to use the Internet, and how to find information quickly. Additionally, the

Company is generating advertising revenue on its **Website** from **direct** ad banner placements as well as **from** shared revenue relationships with content partners such as Excite, Inc. and Lycos, Inc.

The Company employs in-house public relations personnel and contracts with an outside public relations agency to provide broad coverage in **network** computer and vertical industry publications. The Company also participates in industry trade shows with and without its strategic marketing partners and conducts numerous seminar “road shows” for market awareness and lead generation.

Customer Service

Concentric believes that a high level of customer support is critical to attracting and retaining its enterprise and consumer customers. The Company’s customer support strategy is based on the following principles:

- our technical expertise in devising cost-effective network solutions for customers;
- rapid development time and flexibility in meeting customer applications requirements; and
- responsive customer support and effective account management.

The Company maintains a customer support call center at its Saginaw, Michigan facility. Concentric ~~offers~~ several levels of customer support all of which are available 24 hours per day, seven days per week. The basic level of customer support includes support for customers on installing and using their **software**, customer communications and customer training. Premier level service programs guarantee an exceptional **performance** standard, ~~offer~~ supplemental support training, and provide monthly reports on operations. Private label support gives businesses a premier level of support provided by their own customer service team who answer calls with that customer’s company name. Customer support is provided by **email**, telephone, **Website** and online chat. As of December 31, 1998, the Company employed 171 persons in customer support.

Competition

The market for tailored value-added network services is extremely competitive. There are no substantial barriers to entry, and the Company expects that competition will intensify in the future. The Company believes that its ability to compete successfully depends upon a number of factors, including market presence; the capacity, reliability, low latency and security of network **infrastructure**; technical expertise and functionality, **performance** and quality of services; customization; ease of access to and navigation of the Internet; the pricing policies of its competitors; the variety of services; the timing of introductions of new services by the Company and its competitors; customer support; the Company’s ability to support industry standards; and industry and **general** economic trends.

The Company’s current and prospective competitors generally may be divided into four groups. These groups and examples of key competitors in each group are listed below:

- | | |
|---|--|
| <ul style="list-style-type: none">· <i>telecommunications companies</i> | AT&T
MCI WorldCom
Sprint
Qwest
Level 3 Communications, Inc.
the RBOCs and other LECs
various cable companies |
| <ul style="list-style-type: none">• <i>online service providers</i> | America Online, Inc. |

CompuServe corporation
MSN, the Microsoft Network
Prodigy Communications Corporation

- *Internet service providers*

BBN Corporation, a subsidiary of GTE
EarthLink Network, Inc.
MindSpring Enterprises, Inc.
PSINet Inc.
Verio Inc.
other national and regional providers

- *Webhosting providers*

AboveNet Communications
Exodus Communications

Many of these competitors have greater market presence, engineering and marketing capabilities, and financial, technological and personnel resources than those available to the Company. As a result, they may be able to develop and expand their communications and network infrastructures more quickly, adapt more swiftly to new or emerging technologies and changes in customer requirements, take advantage of acquisition and other opportunities more readily, and devote greater resources to the marketing and sale of their products than can the Company. In addition, various organizations, including certain of those identified above, have entered into or are forming joint ventures or consortiums to provide services similar to those of the Company.

The Company believes that new competitors, including large computer hardware, software, media and other technology and telecommunications companies will enter the value added network services markets, resulting in even greater competition for the Company. Certain of such telecommunications companies and online services providers are currently offering or have announced plans to offer Internet or online services or to expand their Internet access services. Certain companies, including America Online, MindSpring, PSINet and Verio have also obtained or expanded their Internet access products and services as a result of acquisitions. Such acquisitions may permit the Company's competitors to devote greater resources to the development and marketing of new competitive products and services and the marketing of existing competitive products and services. In addition, the ability of some of the Company's competitors to bundle other services and products with VPN and consumer network services could place the Company at a competitive disadvantage. Certain companies are also exploring the possibility of providing high-speed data services using alternative delivery methods such as over the cable television infrastructure, through direct broadcast satellite technology and by wireless cable. There can be no assurance that the Company will have the financial resources, technical expertise or marketing and support capabilities to continue to compete successfully. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Factors Affecting Operating Results--Our Market Is Extremely Competitive."

Proprietary Rights

The Company's success and ability to compete is dependent in part upon its technology, although the Company believes that its success is more dependent upon its technical expertise than its proprietary rights. The Company principally relies upon a combination of copyright, trademark and trade secret laws and contractual restrictions to protect its proprietary technology. It may be possible for a third party to copy or otherwise obtain and use the Company's products or technology without authorization or to develop similar technology independently, and there can be no assurance that protective measures have been, or will be, adequate to protect the Company's proprietary technology or that the Company's competitors will not independently develop technologies that are

substantially equivalent or superior to the Company's technology. The Company operates a material portion of its business over the Internet, which is subject to a variety of risks. Such risks include but are not limited to the substantial uncertainties that exist regarding the system for assigning domain names and the status of private rules for resolution of disputes regarding rights to domain names. There can be no **assurance** that the Company will continue to be able to employ its current domain names in the **future** or that the loss of rights to one or more domain **names** will not have a material adverse effect on the Company's business and results of operations.

Although the Company does not believe that it **infringes** the proprietary rights of any third parties, we cannot assure you that third parties will not assert such claims against the Company in the **future** or that such claims will not be successful. See "Management's Discussion and Analysis of Financial Condition and Results of Operations-Factors Affecting Operating Results-Third Parties May Claim We Infringe Their Proprietary Rights."

Employees

As of December 31, 1998, Concentric had 508 employees and 61 independent contractors, including 168 persons in sales and marketing, 171 persons in network operations and development, 171 in customer support and 59 in **finance** and administrative functions. The Company believes that its **future** success will depend in part on its continued ability to attract, hire and retain qualified personnel. Competition for such personnel is intense, and We cannot assure you that the Company will be able to identify, attract, and retain such personnel in the future. None of the Company's employees is represented by a labor union, and management believes its employee relations are good.

EXECUTIVE OFFICERS AND DIRECTORS OF THE COMPANY

Executive Officers, Directors and Senior Management

The following table sets forth certain information as of December 31, 1998, with respect to the executive officers and directors of the Company, as well as certain members of its senior management.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Henry R. Nothhaft.....	54	Chairman, President, Chief Executive Officer and Director
John K. Peters.....	50	Executive Vice President and General Manager, Network Services Applications Division
Michael F. Anthofer.....	46	Senior Vice President and Chief Financial Officer
Mark W. Fisher.....	38	Senior Vice President of Corporate Marketing, General Manager, Network Services Division
William C. Etheredge.....	52	Senior Vice President of Sales
Eileen A. Curtis.....	50	Vice President of Customer Relations
James L. Isaacs.....	38	Vice President of Business Development
Vinod Khosla(2).....	44	Director
S. Miller Williams(1).....	47	Director
Franco Regis(1).....	42	Director
Gary E. Rieschel(2).....	42	Director

(1) Member of the Audit Committee.

(2) Member of the Compensation Committee

Henry R. Nothhaft joined the Company as President and Chief Executive Officer in May 1995 and was appointed a Director of the Company in August 1995 and Chairman of the Board in January 1998. From 1989 to August 1994, Mr. Nothhaft was President, Chief Executive Officer and a Director of David Systems, Inc., a networking company. From 1983 to 1989, Mr. Nothhaft held various positions with DSC Communications Corporation, including President of the Business Network Systems Group, President of the Digital Switch Corporation subsidiary, Senior Vice President of Marketing and a Corporate Director of DSC. From 1979 to 1983, Mr. Nothhaft was Vice President of Domestic Marketing and Vice President of Sales for GTE Telenet Communications Corporation (now Sprint). Mr. Nothhaft has an M.B.A. in Information Systems Technology from George Washington University and a B.S. from the U.S. Naval Academy, and is a former officer in the U.S. Marine Corps.

John K. Peters was named Executive Vice President and General Manager, Network Services Applications Division in June 1995. In June 1998, Mr. Peters assumed a new position as Executive Vice President and General Manager, Network Services Application Division. From 1993 to August 1995, Mr. Peters served as President of Venture Development Consulting, a consulting firm specializing in new communications and information services. From 1988 to 1993, Mr. Peters was Vice President and Chief Operating Officer of Pacific Bell Information Services,

Inc. Prior to that, Mr. Peters spent three years as Vice President of Application Services for **Telestream** Corporation. In 1981, Mr. Peters co-founded **Integrated Office Systems, Inc.**, a communications and information systems company. From 1976 to 1980, Mr. Peters was Vice President of Advanced Network Services for **GTE Telenet** Communications Corporation. Mr. Peters has an M.B.A. from Stanford Graduate School of Business and a B.S. in Statistics from Stanford University.

Michael F. Anthofer joined the Company in January 1996 as Vice President and Chief Financial Officer and became a Senior Vice President in November 1996. From January 1991 to December 1995, Mr. Anthofer served as an Executive Vice President and Chief Financial Officer, as well as a member of the Board of Directors, of **Shared Resource Exchange, Inc.**, a privately held digital switching platform and PBX supplier. Prior to 1991, Mr. Anthofer held various executive positions at **DSC Communications Corporation** including Vice President, Corporate Business Planning, Vice President, Business Network Group and Vice President, Network Products Group. Mr. Anthofer has an M.B.A. and a B.S. from the University of California, Berkeley.

Mark W. Fisher joined the Company in June 1997 as Vice President of Corporate Marketing and was promoted to Senior Vice President and General Manager, Network Services Division in July 1998. From July 1996 to June 1997, Mr. Fisher was General Manager and Vice President, Marketing of **Pacific Bell Internet Services**, a wholly owned subsidiary of Pacific Bell. From June 1995 to August 1996, Mr. Fisher was Vice President, Marketing of **Pacific Bell Internet Services**. From 1989 to May 1995, Mr. Fisher held various data product marketing and data center operations positions at Pacific Bell. Mr. Fisher has an M.B.A. from the University of California, Berkeley and a B.S. in mechanical engineering from the U.S. Naval Academy.

William C. Etheredge joined the Company in March 1997 as the Senior Vice President of Sales. From May 1991 to March 1997, Mr. Etheredge served first as Vice President of Sales and Marketing and then as Vice President of Sales for **Meridian Data, Inc.**, a provider of networked CD-ROM database creation and retrieval software and network servers. From July 1990 to May 1991, he served as Vice President of Strategic Accounts for **Maxtor Corporation**. From June 1985 to June 1990, he served first as Vice President US Sales and Marketing and then Vice President Western Region for **Memorex-Telex Corporation**. Mr. Etheredge has an M.B.A. from Bowling Green University and a B.A. from Westminster College.

Eileen A. Curtis became Customer Relations Manager in January 1995, Director of Customer Relations in September 1995 and Vice President, Customer Relations in November 1996. From August 1987 to July 1993, Ms. Curtis was employed by **Cox Communications Saginaw, Inc.** and served in various positions including Marketing and Public Relations Manager, Administrative Manager and Customer Service Manager. Ms. Curtis has an MBA and a B.S. from Central Michigan University.

James L. Isaacs joined the Company in October 1995 as the Director of Product Management. In March 1997, he became Vice President of Product Management and in November 1997 he was appointed Vice President of Business Development. From July 1988 to October 1995, Mr. Isaacs held various positions at **Apple Computer**, including Group Manager Product Marketing, **Apple On Line Services Division** and Business Development Manager of **Apple On Line Services Division**. Mr. Isaacs has an M.B.A. from the University of California, Berkeley and an A.B. from Stanford University.

Vinod Khosla has been a Director of the Company since April 1995. Mr. Khosla has been a General Partner with the venture capital firm of **Kleiner Perkins Caufield & Byers** from February 1986 to the present. Mr. Khosla was a co-founder of **Daisy Systems** and the founding Chief Executive Officer of **Sun Microsystems, Inc.** Mr. Khosla also serves on the boards of **Excite, Inc.**, **PictureTel**, **The 3DO Company**, and **Spectrum Holobyte**. He has a B.S.E. from the **Indian Institute of Technology** in New Delhi, an M.S.E. from **Carnegie Mellon University**, and an M.B.A. from the Stanford Graduate School of Business.

S. Miller Williams has been a Director of the Company since September 1998. Mr. Williams is Vice President of Corporate Development for **Williams Communications Group, Inc.**, a subsidiary of **Williams Companies, Inc.**, a position he has held since 1992. Mr. Williams has a B.S. in Business Administration from the University of North Carolina and an M.B.A. from the University of Tulsa.

Franco Regis has been a Director of the Company since October 1996. Since 1994, Mr. Regis has been a Director of Business Development and Strategic Planning at Telecom **Italia, SpA**, the telephone operating company of Italy. From 1992 to 1994, Mr. Regis was a Director of Budget and Control for the business division of Telecom **Italia**. Mr. Regis has an engineering degree from the Rome State University.

Gary E. Rieschel has been a Director of the Company since October 1996. Mr. Rieschel is Executive Managing Partner at **SOFTBANK** Technology Ventures, having joined that company in January 1996. Mr. Rieschel was Vice President for N-Cube Corporation from August 1994 through December 1995. He was Sales Director at **Cisco** Systems, Inc. from July 1993 through October 1994. Prior to this, Mr. Rieschel was a General Manager and Sales Director at Sequent Computer for over nine years. Mr. Rieschel has an M.B.A. from Harvard Graduate School of Business and a B.A. in biology from Reed College.

Classified Board of Directors

The Company's Certificate of Incorporation provides that, so long as the Board of Directors consists of more than two directors, the Board of Directors will be divided into three classes of directors serving staggered three-year terms. As a result, one-third of the Company's Board of Directors will be elected each year.

Director Compensation

Directors are reimbursed for certain reasonable expenses incurred in attending Board or committee meetings. Officers of the Company are elected annually by the Board of Directors and serve at its discretion. The Company has entered into indemnification agreements with each member of the Board of Directors and certain of its officers providing for the indemnification of such person to the fullest extent authorized, permitted or allowed by law.

Compensation Committee

The Company's Board of Directors currently has a Compensation Committee that reviews and approves the compensation and benefits to be provided to the officers, directors, employees, and consultants of the Company, administers the Company's 1993 Incentive Stock Option Plan, 1995 Stock Incentive Plan for Employees and Consultants, and Amended and Restated 1996 Stock Plan, and the 1997 Stock Plan and 1997 Employee Stock Purchase Plan. The Compensation Committee currently consists of Messrs. Khosla and Rieschel.

Audit Committee

The Company's Board of Directors currently has an Audit Committee that monitors the **corporate financial** reporting and the external audits of the Company, reviews and approves material accounting policy changes, monitors internal **accounting** controls, recommends engagement of independent auditors, reviews related-party transactions and performs other duties as prescribed by the Board of Directors. The Audit Committee currently consists of Messrs. Bender and Regis.

ITEM 2. PROPERTIES

The Company's executive offices are located in San Jose, California, under a lease expiring on February 1, 2006. The Company also leases network operations facilities in Bay City, Michigan, under a lease expiring on December 31, 1999, data centers in Chicago, Illinois, under a lease expiring on June 30, 2008, in Santa Clara, California, under a lease expiring on May 31, 2000, in Newport Beach, California, under a lease expiring on June

30, 1999, and in Anaheim, California, under a lease expiring on June 30, 1999, and a customer support facility in Saginaw, Michigan under a lease expiring in December 2001.

ITEM 3. LEGAL PROCEEDINGS

In late April and early May, 1997, three putative securities class action complaints were filed in the United States District Court, Central District by certain stockholders of Diana, the parent corporation of Sattel, alleging securities fraud related to plaintiffs' purchase of shares of Diana Common Stock in reliance upon allegedly misleading statements made by defendants, Diana, Sattel and certain of their respective affiliates, officers and directors. Concentric was named as a defendant in the complaint in connection with certain statements made by Diana and officers of Diana related to Concentric's purchase of network switching equipment from Diana's Sattel subsidiary. The plaintiffs sought unspecified compensatory damages. A motion by the Company to dismiss the complaint was denied, and the court has allowed the action to proceed against the Company. The parties have agreed in principal to settle the case and expect to enter the settlement agreement with the court in February 1999.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock has been traded on the Nasdaq National Market under the symbol "CNCX" since our initial public offering on August 1, 1997. The following table sets forth, for the periods indicated, the high and low sale prices for our common stock as reported by the Nasdaq National Market:

	<u>High</u>	<u>Low</u>
Fiscal Year Ended December 31, 1997:		
Third Quarter (from August 1, 1997).....	\$16	\$11 ³ / ₈
Fourth Quarter	15	7 ⁷ / ₈
Fiscal Year Ended December 31, 1998:		
First Quarter.....	\$20 ³ / ₈	\$ 8 ⁷ / ₈
Second Quarter... ..	31 ¹ / ₂	18 ⁵ / ₈
Third Quarter.....	41	14 ¹ / ₄
Fourth Quarter	37 ¹ / ₄	14 ¹ / ₂
Fiscal Year Ending December 31, 1999:		
First Quarter (through January 29, 1999)	\$47 ¹ / ₂	\$31 ⁷ / ₈

On January 29, 1999, the last reported sale price for our common stock on the Nasdaq National Market was 543.50 per share. As of January 20, 1999, we estimate that there were approximately 271 holders of record and over 4.388 beneficial owners of the common stock.

The Company currently intends to retain any earnings for use in its business and does not anticipate paying any cash dividends in the foreseeable future.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data should be read in conjunction with the Consolidated Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" commencing, on page 24.

	Year Ended December 31,				
	1994	1995	1996	1997	1998(1)
	(In thousands, except per share data)				
Consolidated Statement of Operations Data:					
Revenue	\$ 442	\$ 2,483	\$ 15,648	\$ 45,457	\$ 82,807
cost of revenue	2,891	16,168	47,945	61,439	85,352
Network equipment write-off(2)	—	—	8,321	—	—
Development	534	337	2,449	4,850	7,734
Marketing and sales	639	3,899	16,609	24,622	39,793
General and administrative	611	2,866	3,445	4,790	10,398
Amortization of goodwill and other intangible assets	—	—	—	—	3,842
Acquisition-related charges	—	—	—	—	1,291
Write-off of in-process technology	—	—	—	—	5,200
Total costs and expenses	4,675	23,770	78,769	95,701	153,610
Loss from operations	(4,233)	(21,287)	(63,121)	(50,244)	(70,803)
Other income (expense)	—	—	—	1,233	(750)
Net interest expense	(57)	(721)	(3,260)	(6,571)	(13,595)
Loss before extraordinary item	(4,290)	(22,008)	(66,381)	(55,582)	(85,148)
Extraordinary gain on early retirement of debt	—	—	—	—	3,042

Net loss	(4,290)	(22,008)	(66,381)	(55,582)	(82,106)
Preferred stock dividends and accretion	—	—	—	—	(11,958)
Net loss attributable to common stockholders	\$ (4,290)	\$ (22,008)	\$ (66,381)	\$ (55,582)	\$ (94,064)
Net loss per share attributable to common stockholders(3)			\$ (13.46)	\$ (5.63)	\$ (6.47)
Shares used in computing net loss per share attributable to common stockholders(3)			4,937	9,872	14,547

As of December 31,
1994 1995 1996 1997 1998
(In thousands)

Consolidated Balance Sheet Data:

Cash and cash equivalents	\$ 63	\$ 19,054	\$ 17,657	\$ 119,959	\$ 98,988
Short term investments					52,226
Restricted cash(4)	—			52,525	36,238
Property and equipment, net	1,303	16,289	47,927	53,710	64,268
Total assets	1,798	37,235	70,722	244,489	298,257
Notes payable and capital lease obligations, net of current portion	1,648	11,047	30,551	179,172	156,455
Redeemable exchangeable preferred stock	—	—	—	—	156,105
Total stockholders' equity (deficit)	(4,202)	9,763	2,925	31,918	(56,875)

(Footnotes appear on the next page.)

- (1) During 1998, the Company acquired InterNex, DeltaNet and AnaServe, the effects of which have been included in the 1998 financial results. See Note 13 of Notes to Consolidated Financial Statements.
- (2) See "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 3 of Notes to Consolidated Financial Statements.
- (3) Net loss per share and shares used in computing net loss per share attributable to common stockholders are presented on a pro forma basis for the years ended December 31, 1996 and 1997 and on an historical basis for the year ended December 31, 1998. See Note 1 of Notes to Consolidated Financial Statements.
- (4) Restricted cash of \$36.2 million consists of funds held in escrow to pay interest relating to the Company's 12³/₄% Senior Notes. See Note 5 of Notes to Consolidated Financial Statements.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This section and other parts of this Report contain forward-looking statements that involve risks and uncertainties. The Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in the subsection entitled "Factors Affecting Operating Results" commencing on page 32. The following discussion of the financial condition and results of operations of the Company should be read in conjunction with the Financial Statements and the Notes thereto included elsewhere in this Report.

Overview

The Company was founded in 1991. From 1991 to mid-1993, the Company conducted development and network services planning activities and realized no revenues. Initially, the Company was focused on providing consumers with direct dial-up **connectivity to bulletin board services. Online** gaming and **entertainment services** for consumers were commenced in July 1993 through the utilization of a third party network infrastructure. The Company commenced operation of its own network in late 1994. In May 1995, new management led by Henry R. Nothhaft redefined and broadened the Company's strategy to provide a range of Internet and tailored, value-added Internet Protocol-based network services to consumers and businesses.

The Company's revenue prior to 1996 was primarily generated from providing Internet access to consumers. The Company's current focus is on developing and deploying VPNs and providing dedicated network access and Web hosting services for enterprise customers. Contracts with **enterprise** customers typically have a term ranging from one to three years. The Company expects enterprise-related revenue to represent an increasing portion of total revenue in future periods. The foregoing expectation is a forward-looking statement that involves risks and uncertainties, and actual results could vary as a result of a number of factors including the Company's operating results, the results and timing of the Company's launch of new products and services, governmental or regulatory changes, the ability of the Company to meet product and project demands, the success of the Company's marketing efforts, competition and acquisitions of complementary businesses, technologies or products.

In February 1998, the Company acquired InterNex, a provider of network services, collocation services and Web hosting facilities to enterprise customers. This acquisition was accounted for using the purchase method of accounting. Accordingly, the Company's historical financial statements do not include results of operations, financial position or cash flows of InterNex prior to its acquisition in February 1998. In addition, as a result of the acquisition, the Company incurred a charge of \$5.2 million relating to acquired in-process technology and recorded an aggregate of \$12.6 million of goodwill and other intangible assets, which will be amortized on a straight-line basis over their estimated useful lives ranging from two to five years.

In May 1998, the Company acquired DeltaNet, a provider of dial-up and dedicated access services, Web hosting services and Web application development and design. This transaction was accounted for as a pooling of interests. Results of DeltaNet's operations for the period beginning April 1, 1998 through December 31, 1998 are included in the consolidated results of operations. In addition, as a result of the acquisition, the Company has incurred charges of approximately \$1.3 million in transaction costs consisting primarily of severance costs, redundant facilities and assets and professional fees related to the acquisition.

In August 1998, the Company acquired AnaServe, a provider of Web hosting services. This acquisition was accounted for using the purchase method of accounting. The Company's historical financial statements do not include results of operations, financial position or cash flows of AnaServe prior to its acquisition. As a result of the acquisition, the Company has recorded an aggregate of \$12.0 million of goodwill and other intangible assets, which will be amortized on a straight-line basis over their useful lives ranging from one to five years.

The Company may acquire other complementary products, technology and businesses. If the Company were to incur additional charges for acquired in-process technology, amortization of goodwill and acquisition costs with respect to any future acquisitions, the Company's business, operating results and financial condition could be

materially **and** adversely affected. See “Factors Affecting Operating **Results—Our** Acquisition Strategy Poses Several Risks” and “-Liquidity and Capital Resources.”

The Company has incurred net losses and experienced negative cash flow **from** operations since inception and expects to continue to operate at a net loss and experience negative cash flow at least through the remainder of 1999. The Company’s ability to achieve profitability and positive cash flow **from** operations is dependent upon the Company’s ability to substantially grow its revenue base and achieve **other** operating efficiencies. The Company experienced net losses attributable to common stockholders of approximately \$66.4 million, \$55.6 million and \$94.1 million for the years ended December 31, 1996, 1997, and 1998, respectively. We cannot assure you that the Company will be able to achieve or sustain revenue growth, profitability or positive cash flow on either a quarterly or an annual basis. At December 31, 1998, the Company had approximately \$90.0 million of gross deferred tax assets comprised primarily **of net** operating loss **carry-forwards**. The Company believes that, based on a number **of** factors, the available objective evidence creates sufficient uncertainty **regarding** the realizability of the deferred tax assets such that a **full** valuation allowance has been recorded. These **factors** include the Company’s history of net losses since its inception and the fact that the market in which the Company competes is intensely competitive and characterized by rapidly changing technology. The Company believes that, based on the current available evidence, it is more likely than not that the Company will not generate taxable income through 1999, and possibly beyond, and accordingly will not realize the Company’s deferred tax assets through 1999, and possibly beyond. The Company will continue to assess the realizability of the **deferred** tax assets based on **actual** and forecasted operating results. In addition, the utilization of net operating losses may be subject to a substantial annual limitation due to the “change in ownership” provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization. See “Factors Affecting Operating Results-We Have a Limited Operating History and Expect Continuing Operating Losses.”

The Company expects to focus in the near term on building and increasing its revenue base, which will require it to significantly increase its expenses for personnel, marketing, network **infrastructure** and the development of new services, and may adversely impact short term operating results. As a result, the Company believes that it will incur losses in the near **term** and we cannot assure you that the Company will be profitable in the **future**.

The Company’s operating results have fluctuated in the past and may in the future fluctuate significantly, depending upon a variety of factors, including the timely deployment and expansion of the Concentric network and new network architectures, the **incurrence** of related capital costs, variability and length of the sales cycle associated with the Company’s product and service offerings, the receipt of new value-added network services and consumer services subscriptions and the introduction **of new** services by the Company and its competitors. Additional factors that may contribute to variability of operating results include: the pricing and mix of services offered by the Company; customer retention rate; market acceptance of new and enhanced versions of the Company’s services; changes in pricing policies by the Company’s competitors; the Company’s ability to obtain **sufficient** supplies **of** sole- or limited-source components; user demand for **network** and Internet access services; balancing of network usage over a 24-hour period; the ability to manage potential growth and expansion; the ability to identify, acquire and integrate successfully suitable acquisition candidates; and charges related to acquisitions. In response to competitive pressures, the Company may take certain pricing or marketing actions that could have a material adverse effect on the Company’s business. As a result, variations in the timing and amounts of revenues could have a material adverse effect on the Company’s quarterly operating results. Due to the foregoing factors, the Company believes that period-to-period comparisons of its operating results are not necessarily meaningful and that such comparisons cannot be relied upon as indicators of **future** performance. In the event that the Company’s operating results in any **future** period fall below the expectations of securities analysts and investors, the trading price of the Company’s common stock would likely decline.

Results of Operations

Year Ended December 31, 1998 Compared to Year Ended December 31, 1997.

Revenue. Revenue totaled approximately \$82.8 million for the year ended December 31, 1998, a \$37.3 million increase **over** revenue of approximately \$45.5 million for the year ended December 31, 1997. This increase reflects growth in revenue **from**:

- the Company's broadened product offerings to its enterprise customers;
- the Company's **marketing arrangements** with its strategic **partners**;
- continued growth in revenue derived from Internet access customers;
- revenue generated **from** network, **colocation** and Web hosting services provided by the Company's wholly-owned subsidiary, **InterNex**, which was acquired in February 1998; and
- revenues from **DeltaNet** and **AnaServe** which were acquired in May and August 1998, respectively.

The Company expects revenue growth **from** Internet access customers to flatten over time as **it** de-emphasizes this sector of its business. Revenue from WebTV declined to 26.8% of the Company's net revenue for the year ended December 31, 1998 compared to 33.4% for the year ended December 31, 1997. The Company expects **revenue** from **WebTV** to decrease as a percentage of revenue. The foregoing expectation is a **forward** looking statement that involves risks and uncertainties and the actual results could vary materially as a result of a number of factors including those set forth under the caption "Factors Affecting Operating Results-The Loss of Any of Our Major Customers Could Severely Impact Our Business."

Cost of Revenue. Cost of revenue consists primarily of personnel costs to maintain and operate the Company's network, access charges from local exchange **carriers**, backbone and Internet access costs, depreciation **of** network equipment and amortization of related assets. Cost of revenue for the year ended December 31, 1998 was approximately \$85.4 million, an increase of \$24.0 million from cost of revenue of \$61.4 million for the year ended December 31, 1997. This increase is attributable to the overall growth in the size of the network and costs associated with acquired operations. As a percentage of revenue, such costs declined to 103.1% of revenue in the year ended December 31, 1998, down **from** 135.2% of revenue in the prior year, due to increased network utilization associated with the Company's revenue growth and lower per port costs of the Company's network architecture. The Company expects its cost of revenue to continue to increase in dollar amount, while declining as a percentage **of** revenue as the Company expands its customer base. The foregoing expectation is a forward looking **statement** that involves risks and uncertainties and the **actual** results could vary materially as a result of a number of factors, including those set forth under the captions "Factors Affecting Operating Results-We Have a Limited Operating History and Expect Continuing Operating Losses," "Factors Affecting Operating Results-Our Growth and Expansion May Strain Our Resources" and "Factors Affecting Operating Results-We Depend Upon New and Uncertain Markets."

Development Expense. Development expense consists primarily of personnel and equipment related expenses associated with the development of products and services of the Company. Development expense was approximately \$7.7 million and \$4.9 million for the years ended December 31, 1998 and 1997, respectively. This higher level **of** development expense reflects an overall increase in personnel to develop new product offerings, to manage the overall growth in the network and **from** acquired operations. Development expense as a percentage of revenue declined to 9.3% for the year ended December 31, 1998 from 10.7% for the year ended December 31, 1997 as a result of the Company's increased revenue. The Company expects its development spending to continue to increase in dollar amount, but to decline as a percentage of revenue. The foregoing expectation is a forward looking **statement** **that** involves risks and uncertainties and the **actual** results could vary materially as a result of a number of factors, including those set forth below under the captions "Factors Affecting Operating Results-We Have a Limited

Operating History and Expect Continuing Operating Losses” and “Factors Affecting Operating Results-We Depend Upon New and Enhanced Services.”

Marketing and Sales Expense. Marketing and sales expense consists primarily of personnel expenses, including salary and commissions, costs of marketing programs and the cost of 800 number circuits utilized by the Company for customer support functions. Marketing and sales expense was approximately \$39.8 million for the year ended December 31, 1998 and \$24.6 million for the year ended December 31, 1997. The \$15.2 million increase in 1998 reflects a substantial investment in the customer support, marketing and sales organizations necessary to support the Company’s expanded customer base. This increase also reflects a growth in subscriber acquisition costs, related to both increased direct marketing efforts as well as commissions paid to distribution partners. Marketing and sales expense as a percentage of revenue declined to 48.1% for the year ended December 31, 1998 from 54.2% in the year earlier period as a result of the Company’s increased revenue. The Company expects marketing and sales expenditures to continue to increase in dollar amount, but to decline as a percentage of revenue. The foregoing expectation is a forward looking statement that involves risks and uncertainties and the actual results could vary materially as a result of a number of factors including those set forth under the captions “Factors Affecting Operating Results-We Depend on New and Uncertain Markets” and “Factors Affecting Operating Results-Our Growth and Expansion May Strain Our Resources.”

General and Administrative Expense. General and administrative expense consists primarily of personnel expense and professional fees. General and administrative expense was approximately \$10.4 million for the year ended December 31, 1998 and \$4.8 million for the year ended December 31, 1997. This higher level of expense reflects an increase in personnel and professional fees necessary to manage the financial, legal and administrative aspects of the business. General and administrative expense as a percentage of revenue increased to 12.6% for the year ended December 31, 1998 from 10.5% in the prior year as a result of the Company’s increased facilities costs and expenses related to updating the Company’s information systems. The Company expects general and administrative expense to increase in dollar amount, reflecting its growth in operations, but to decline as a percentage of revenue. The foregoing expectation is a forward looking statement that involves risks and uncertainties and the actual results could vary materially as a result of a number of factors including those set forth under the captions “Factors Affecting Operating Results-We Depend on New and Uncertain Markets” and “Factors Affecting Operating Results-Our Growth and Expansion May Strain Our Resources.”

Amortization of Goodwill and Other Intangible Assets. For the year ended December 31, 1998, the Company recorded amortization of goodwill and other intangible assets of \$3.8 million resulting from the acquisition of InterNex in February 1998 and AnaServe in August 1998.

Acquisition-Related Charges. For the year ended December 31, 1998 the Company charged to operations one-time acquisition costs of \$1.3 million related to the DeltaNet acquisition. Those costs principally related to professional fees, reserves for redundant assets and facilities and employee severance packages.

Write-off of In-Process Technology. For the year ended December 31, 1998, the Company wrote-off \$5.2 million of in-process technology related to the acquisition of InterNex. This acquisition provided technology and expertise that the Company is using to enhance and expand the breadth of its product and service offerings to its customers.

Other Income (Expense). During the year ended December 31, 1998, the Company recorded \$750,000 of other expense in connection with the settlement of certain litigation with the shareholders of Diana Corporation. During the year ended December 31, 1997, upon settlement of the Sattel litigation, the Company recorded \$970,000 of other income related to the reversal of previously established reserves. Additionally, the Company recorded \$425,000 of other income related to the negotiation of a third party services agreement,

Net Interest Expense. Net interest expense was approximately \$13.6 million and \$6.6 million for the years ended December 31, 1998 and 1997, respectively. The increase is primarily due to interest related to \$150.0 million principal amount of 12³/₄% Senior Notes issued in December 1997.

Extraordinary Gain. For the year ended December 31, 1998, the Company realized an extraordinary gain of \$3.0 million related to the early retirement of debt in the form of capital lease obligations.

Preferred Stock Dividends and Accretions. For the year ended December 31, 1998, the Company recorded dividend and stock accretion of \$12.0 million related to the preferred stock issued in June 1998.

Net Loss Attributable to Common Stockholders. The Company's net loss attributable to common stockholders increased to approximately \$94.1 million for the year ended December 31, 1998 as compared to approximately \$55.6 million for the year ended December 31, 1997. For comparative purposes, the net loss attributable to common stockholders for the year ended December 31, 1998 included expenses related to financing and acquisition charges of \$1.3 million resulting from the acquisition of DeltaNet, \$12.0 million of dividends and accretion related to the preferred stock issued in June 1998, \$19.9 million of interest expense and amortization of debt issuance costs related to the 12³/₄% Senior Notes and warrants, \$5.2 million write-off of in-process technology and \$3.8 million of amortization of goodwill and other intangibles relating to the acquisitions of InterNex and AnaServe. These losses were partially offset by an extraordinary gain of \$3.0 million on early retirement of debt.

Year Ended December 31, 1997 Compared to Year Ended December 31, 1996.

Revenue. Revenue for the year ended December 31, 1997 totaled approximately \$45.5 million, an increase of \$29.9 million over revenue of \$15.6 million for the year ended December 31, 1996. This increased revenue reflects growth in revenue from the Company's broadened product offerings to its enterprise customers and through the Company's leveraged marketing arrangements with its strategic partners, as well as continued growth in revenue derived from Internet access customers. WebTV accounted for approximately 33.4% of total revenue for the year ended December 31, 1997.

Cost of Revenue. Cost of revenue for the year ended December 31, 1997 totaled approximately \$61.4 million compared with \$47.9 million for the year ended December 31, 1996. This increase is attributable to the overall growth in the size of the network. As a percentage of revenue, costs declined to 135.2% of revenue in the year ended December 31, 1997 from 306.4% of revenue in the prior year due to increased network utilization associated with the Company's revenue growth and lower per port costs of the Company's SuperPOP network architecture deployed in the second half of 1996.

Development Expense. Development expense for the years ended December 31, 1997 and 1996 was approximately \$4.9 million and \$2.4 million, respectively. This higher level of development expense reflects an overall increase in personnel to develop new product offerings and to manage the overall growth in the network. As a percent of revenue, development expense declined to 10.7% for the year ended December 31, 1997 from 15.7% for the year ended December 31, 1996, as a result of the Company's increased revenue.

Marketing and Sales Expense. For the years ended December 31, 1997 and 1996, marketing and sales expense was approximately \$24.6 million and \$16.6 million, respectively. The \$8.0 million increase in 1997 reflects a substantial investment in the customer support, marketing and sales organizations necessary to support the Company's expanded customer base. This increase also reflects a growth in subscriber acquisition costs, related to both increased direct marketing efforts as well as commissions paid to distribution partners. Additionally, the increase reflects the ramp-up of marketing efforts related to the introduction of enterprise products and services. Marketing and sales expense as a percentage of revenue declined to 54.2% for the year ended December 31, 1997 from 106.1% in the year earlier period as a result of the Company's increased revenue.

General and Administrative Expense. For the years ended December 31, 1997 and 1996, general and administrative expenses were approximately \$4.8 million and \$3.4 million, respectively. This higher level of expense reflects an increase in personnel and professional fees necessary to manage the financial, legal and administrative aspects of the business. For the year ended December 31, 1997, general and administrative expense declined to 10.5% from 22.0% for the year ended December 31, 1996 as a result of the Company's increased revenue.

Other Income (Expense). During the year ended December 31, 1997, upon settlement of the **Sattel** litigation, the Company recorded \$970,000 of other income related to **the** reversal of previously established reserves. Additionally, the Company recorded \$425,000 of other income related to the re-negotiation of a third party services agreement. The Company recorded no other income or expense during the year ended December 31, 1996.

Net Interest Expense. Net interest expense was approximately \$6.6 million and \$3.3 million for the years ended December 31, 1997 and 1996, respectively. The increase for the year ended December 31, 1997 was primarily due to a cost of financing charge of \$930,000 associated with the value of warrants issued in connection with **\$5.0** million of **bridge** loans received in June 1997 and \$744,000 associated with the issuance of the 12³/₄% Senior Notes. Additionally, the principal amount of capitalized lease obligations increased \$7.0 million from December 31, 1996 to December 31, 1997. The year ended December 31, 1996 included approximately \$330,000 associated with the value of warrants issued in connection with bridge loan financing.

Net Loss. For the year ended December 31, 1997 the **net** loss totaled \$55.6 million as compared to \$66.4 million for the year ended December 31, 1996.

Liquidity and Capital Resources

To date, the Company has satisfied its cash requirements primarily **through** capitalized lease **financings**, the sale of capital stock and debt **financings**. The Company's principal uses of cash are to fund working capital requirements and capital expenditures, to service its capital lease and debt financing obligations, to finance and fund acquisitions and to provide for the early retirement of debt. Net cash used in operating activities for the years ended December 31, 1998 and 1997 was approximately \$46.6 million and \$45.9 million, respectively. Included in the amount for the year ended December 31, 1997 is \$4.4 million of cash paid in settlement of a dispute with **an** equipment provider. Cash used in operating activities in both periods was primarily **affected** by the net losses, caused by increased costs related to the expansion of the Company's network and organizational **infrastructure**.

Net cash used in investing activities for the years ended December 31, 1998 and 1997 was approximately \$101.9 million and \$6.5 million, respectively. Net cash used in investing activities for the year ended December 31, 1998 consisted primarily of \$52.2 million used to purchase short term investments, \$23.5 million used **for** purchases of capital equipment to support the Company's expanded network infrastructure and \$25.1 million of cash used to acquire InterNex and AnaServe. For the year ended December 31, 1997, net cash used in investing activities was primarily for purchases of capital equipment.

For the year ended December 31, 1998, net cash of \$127.6 million was provided from financing activities, reflecting \$144.1 million of **net** proceeds from the issuance of preferred stock in June 1998 less \$24.8 million used for the early retirement of capital lease obligations, \$10.2 million used for repayment of other capital **lease** obligations and restricted cash of \$16.3 million used to pay interest on the 12³/₄% Senior Notes. For the year ended December 31, 1997 net cash of approximately \$154.7 million was generated **from** financing activities, of which \$74.0 million, net of issuance costs, was derived from the issuance of stocks and warrants and \$145.0 million, net **of** issuance costs, was derived from the issuances **of the** 12³/₄% Senior Notes, net of \$52.5 million investment in U.S. Government treasury strips held as restricted cash. The Company also received \$5.0 million in debt **financing** in June 1997, of which \$2.0 million was repaid, and \$3.0 million was converted into common stock, respectively, upon closing of the Company's initial public offering in August 1997. Concurrent with the closing of the initial public offering, the Company repurchased \$2.2 million of common stock **from** certain stockholders. **The** remainder of financing activities for the year ended December 31, 1997 is comprised of \$11.6 million used for repayment **of** capital lease obligations. The net cash decrease for the year ended December 31, 1998 was \$21.0 million as compared to a net cash increase for the year ended December 31, 1997 of \$102.3 million.

At December 31, 1998, the Company had cash and cash equivalents of approximately \$99.0 million, short term investments of \$52.2 million, restricted cash of \$36.2 million and working capital of \$144.5 million. The Company expects to incur additional operating losses and will rely primarily on its available cash resources, the net

proceeds from the issuance of the common stock and financing available under a network equipment lease agreement (that currently has no maximum borrowing limit) to meet its anticipated cash needs for working capital and for the acquisition of capital equipment through at least the end of 1999. However, we cannot assure you that the Company will not require additional financing within this time **frame**. The Company's forecast of the period of time through which its **financial** resources will be adequate to support its operations is a forward-looking statement that involves risks and uncertainties, and actual results could vary materially as a result of a number of factors, including those set forth on under the caption "Factors Affecting Operating Results-We May Need Additional Capital in the Future and Such Additional Financing May Not Be Available." The Company may be required to raise additional funds through public or private financing, strategic relationships or other arrangements. We cannot assure you that such additional funding, if needed, will be available on terms attractive to **the Company**, or **at all**.

In January 1999, the Company used approximately \$10.0 million in cash to purchase 555,556 shares of Covad's common stock. The investment was made as part of a broader strategic relationship with Covad. The shares of common stock were purchased at Covad's initial public offering price of \$18.00 per share. Additionally, SBC purchased approximately \$19.5 million of **common** stock **from** the Company **in January** 1999.

In January 1999, the Company filed a registration statement with the Securities and Exchange Commission for a proposed public offering of up to 2,875,000 shares of common stock. The proceeds of the **offering** will be used for general corporate purposes.

Disclosures About Market Risk

The following discusses the Company's exposure to market risk related to changes in interest rates, equity prices and foreign currency exchange rates. This discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results could vary materially as a result of a number of factors including those set forth under the captions "Factors Affecting Operating Results-We Have Incurred Substantial Indebtedness and May Not Be Able to Service Our Debt" and "Factors Affecting Operating Results-We May Need Additional Capital in the Future and Such Additional Financing May Not Be Available."

Interest Rate Sensitivity.

Short-Term Investments Owned By the Company. As of December 31, 1998, the Company had short term investments of \$52.2 million. These short-term investments consist of highly liquid investments with original maturities at the date of purchase of between three and twelve months. These investments **are** subject to interest rate risk and will fall in value if market interest rates **increase**. A hypothetical increase in market interest rates by 10 percent from levels at December 31, 1998 would cause the fair value of **these** short-term investments to decline by an immaterial amount. The Company has the ability to hold these investments until maturity, and therefore the Company would not expect the value of these investments to be affected to any significant degree by the effect of a sudden change in market interest rates. Declines in interest rates over time will, however, reduce the Company's interest income.

Outstanding Debt of the Company. As of December 31, 1998, the Company had outstanding long term debt of approximately \$150.0 million at a fixed interest rate of 12³/₄% and \$150.0 million of preferred stock outstanding with a dividend rate of 13¹/₂%. In certain circumstances, the Company may redeem this preferred stock or exchange long-term debt for this **preferred** stock. Because the interest and dividend rates **on** these **instruments are** fixed, a hypothetical 10 percent decrease in interest rates would not have a material impact on the Company. **Increases** in interest rates could, however, increase the interest expense associated with **future** borrowings by the Company, if any. The Company does not hedge against interest rate increases.

Equity Price Risk.

The Company **owns** 555,556 shares of the common stock of **Covad**. The Company purchased these shares at the time of Covad's initial public offering in January 1999 at a price of \$18.00 per share. On **January** 25, 1999, the closing price of Covad's common stock was \$51.88 per share. The Company values this investment using the lower of cost or market method, and thus continues to value this investment at its cost of **\$10.0** million. If the price of **Covad** common stock were to decline below \$18.00 per share and such decline was considered to be other than temporary, the Company would be required to write-down the value of this investment. The Company is generally restricted **from** selling these shares for at least one year from the date of their purchase. The Company does not hedge against equity price changes.

Foreign Currency Exchange Rate Risk

All of the Company's revenues are realized in dollars and substantially all of the Company's revenues **are from** customers in the United States. Therefore, the Company does not believe it has any significant direct **foreign currency** exchange rate risk. The Company does not hedge against foreign currency exchange rate changes.

Impact of The Year 2000 Issue

The Year 2000 issue is the result of computer programs being written using **two** digits rather than four to **define** the applicable year. As a result, date-sensitive software may recognize a date using "**00**" as the year 1900 rather than the year 2000. This could result in system failures or miscalculations causing disruptions of normal business activities. The Company is currently in the process of reviewing its products and services, as well as its internal management information systems in order to identify and modify those products, services and systems that **are** not year 2000 compliant.

Based on the Company's assessment to date, the Company has determined that its internally developed software, including much of its operational, **financial** and management information systems software is year 2000 compliant. The Company's operational, **financial** and management information systems **software** which have not been internally developed have been certified as year 2000 compliant by the third party vendors who have supplied the software. The equipment and **software** that **runs** the Company's data centers are **supplied by** Microsoft, Nortel/Bay Networks and Sun Microsystems. The Company has implemented **software** patches supplied by Microsoft so that the Microsoft software in these data centers no longer contains any material year 2000 deficiencies. The Company implemented similar patches for the **software** supplied by **Sun** Microsystems at the end of **1998** and expects to replace the Bay **Networks** equipment and software by the end of March 1999 with versions which do not contain any material year 2000 deficiencies. The Company expects such modifications will be made on a timely basis and does not believe that the cost of such modifications will have a material effect on the Company's operating results. Additionally, the Company is continuing to assess the year 2000 compliance of its products and services. To date, most newly introduced products and services of the Company do not contain material year 2000 deficiencies, however some of the Company's customers are running earlier product versions that are not year 2000 compliant. The Company has been encouraging such customers to migrate to current product versions. The Company estimates that the capital and other costs associated with the upgrade and conversion of its existing products, services and systems relating to the year 2000 issue will not be material. The Company does not separately track internal costs incurred to assess and remedy deficiencies related to the year 2000 problem, however, such costs are principally the payroll costs for its information systems group. The Company does not have and is not developing a contingency plan in the event its systems fail as a result of year 2000 related problems.

The Company's products, services and systems operate in complex network environments and directly and indirectly interact with a number of other hardware and software systems. The Company faces risks to the extent that suppliers of products, services and systems purchased by the Company and others with whom the Company transacts business on a worldwide basis, including those which form significant portions of the Company's network and may be sole- or limited-source suppliers, do not have business systems **or** products that comply with year 2000

requirements. The Company has not received significant assurances **from** its suppliers that their networks **are** year 2000 compliant. **If these** networks fail, the Company's business will be significantly impacted.

The Company's expectation that it will be able to upgrade its products, services and systems to address the year 2000 issue and its expectation regarding the costs associated **with** these upgrades are **forward-looking** statements subject to a number of risks and uncertainties. Actual results may vary materially as a result of a number of factors. There can be no assurance that the Company will be able to timely and successfully modify such products, services and systems to comply with year 2000 requirements. Any failure to do so could have a material adverse effect on the Company's operating results. Furthermore, despite testing by the Company and its vendors, the Company's products, services and systems may contain undetected errors or defects associated with year 2000 date functions. **In** the event any material errors or defects are not detected and fixed or third parties cannot timely provide the Company with products, services or systems that meet the year 2000 requirements, the Company's operating results could be materially adversely affected. Known or unknown errors or defects that **affect** the operation of the Company's products, services or systems could result in delay or loss of revenue, interruption of network services, cancellation of **customer** contracts, diversion of development resources, damage to the **Company's** reputation, and litigation costs. There can be no assurance that these or other factors relating to year 2000 compliance issues will not have a material adverse effect on the Company's business, operating results or financial condition.

Factors Affecting Operating Results

As described by the following factors, past financial performance should not be considered a reliable indicator **of** **future performance** and investors should not use historical trends to anticipate results or trends in **future** periods.

We Have a Limited Operating History and Expect Continuing Operating Losses.

We were incorporated in **1991**, commenced network operations in 1994 and completed initial deployment **of** our current network architecture and use of an advanced ATM backbone network in late **1996**. Accordingly, we have a limited operating history upon which an evaluation of our prospects can be based. Our prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving markets. To address these risks, we must, among other things:

- respond to competitive developments;
- continue to attract, retain and motivate qualified personnel; and
- continue to upgrade our technologies **and** commercialize network services incorporating such technologies.

We cannot assure you that we will be successful in addressing the risks we face. The failure to do so could have a material adverse effect on our business, **financial** condition and results of operations.

We have incurred net losses and experienced negative cash flow from operations since inception. We expect to continue to operate at a net loss and experience negative cash flow at least through 1999. Our ability to achieve profitability and positive cash flow from operations is dependent upon **our** ability to substantially grow our **revenue** base and achieve other operating efficiencies. We experienced net losses attributable to common stockholders **of** approximately \$66.4 million for the year ended December 31, 1996, \$55.6 million for the year ended December 31, 1997 and \$94.1 million for the year ended December 31, 1998. At December 31, 1998, we had an accumulated deficit of approximately \$246.1 million. We cannot assure you that we will be able to achieve or sustain revenue growth, profitability or positive cash flow on either a quarterly or an annual basis.

Our estimates of the periods of time in which **we** expect to continue to operate at a net loss, experience negative cash flow and not generate taxable income are forward-looking statements **that** involve risks and uncertainties. Actual

results could vary materially as a result of a number of factors, including those set forth in this Factors Affecting Operating Results section.

Our Operating Results Fluctuate and Could Decline.

Our operating results have fluctuated in the past and may fluctuate significantly in the future. Our operating results fluctuate due to a variety of factors, including the following:

- . timely deployment and expansion of our network and new network architectures;
- . the incurrence of capital costs related to network expansion;
- . variability and length of the sales cycle associated with our product and service offerings;
- . the receipt of new value-added network services and consumer services subscriptions;
- . the introduction of new services by us and our competitors;
- . the pricing and mix of services offered by us;
- . our customer retention rate;
- . market acceptance of new and enhanced versions of our services;
- . changes in pricing policies by our competitors;
- . our ability to obtain sufficient supplies of sole- or limited-source components;
- . user demand for network and Internet access services;
- . balancing of network usage over a 24-hour period;
- . the ability to manage potential growth and expansion;
- . the ability to identify, acquire and successfully integrate suitable acquisition candidates; and
- . charges related to acquisitions

Variations in the timing and amounts of revenues due to these actions could have a material adverse effect on our quarterly operating results. Due to the foregoing factors, we believe that period-to-period comparisons of our operating results are not necessarily meaningful. Such comparisons cannot be relied upon as indicators of future performance. If our operating results in any future period fall below the expectations of securities analysts and investors, the market price of our securities would likely decline.

The Loss of Any of Our Major Customers Could Severely Impact Our Business.

We currently derive a substantial portion of our total revenue from WebTV. Revenue from WebTV accounted for 10.1% of our revenue for the year ended December 31, 1996, 33.4% of our revenue for the year ended December 31, 1997 and 26.8% of our revenue for the year ended December 31, 1998.

WebTV may terminate our current agreement at will after October 31, 2000. While we expect revenue from WebTV to decrease as a percentage of revenue in future periods, we believe that revenue derived from a limited number of customers may continue to represent a significant portion of our revenue. As a result, the loss of one or more of our major customers could have a material adverse effect on our business, financial condition and results of

operations. In addition, we cannot assure you that revenue from customers that have accounted for significant revenue in past periods, individually or as a group, will continue, or will reach or exceed historical levels in any future period.

Our Growth and Expansion May Strain Our Resources.

Our business and service offerings have grown rapidly since our inception. The growth and expansion of our business and our service offerings have placed, and are expected to continue to place, a significant strain on our management, operational and financial resources. In addition, we recently expanded and upgraded our network to use an ATM backbone. We plan to continue to substantially expand our network in 1999 and future periods. To manage our growth, we must, among other things:

- continue to implement and improve our operational, financial and management information systems, including our billing, accounts receivable and payable tracking, fixed assets and other financial management systems;
- hire, train and retain qualified personnel; and
- continue to expand and upgrade our network infrastructure.

We are currently in the process of replacing and updating our operational, financial and management information systems. The systems being replaced and updated include our billing, provisioning and other financial management systems. We began to replace our information systems facilities in the fourth quarter of 1998 and these efforts will continue throughout 1999. We also consolidated our Silicon Valley operations in a new, larger facility in the fourth quarter of 1998 and will transfer our remaining Silicon Valley data centers to this facility during the first two quarters of 1999. Management of the transition of our information systems and of the personnel and operational equipment to the new facility is expected to place additional strain on our resources. We cannot assure you that this transition will be completed successfully or on a timely basis.

We cannot assure you that we will be able to expand our network or add services at the rate or according to the schedule presently planned by us. We had 96 employees and 47 independent contractors as of December 31, 1996, and have grown to 508 employees and 61 independent contractors as of December 31, 1998. We cannot assure you that we will be able to effectively manage this growth in personnel. Additionally, we cannot assure you that we will be able to hire, train and retain sufficient numbers of qualified personnel to meet our requirements.

Our expanding customer base demands the rapid growth of our network infrastructure and technical support resources. We may in the future experience difficulties meeting the demand for our access services and technical support. We cannot assure you that our technical support or other resources will be sufficient to facilitate our growth. We are striving to increase total network utilization and to optimize this utilization by targeting both business and consumer users to balance the network's usage throughout a 24-hour period. There will be additional demands on our customer support, sales and marketing resources as we pursue this utilization strategy. If we fail to manage our growth effectively, our business, financial condition and results of operations could be materially adversely affected.

Our Acquisition Strategy Poses Several Risks.

We have completed three acquisitions to date and may seek to acquire additional assets, technologies and businesses complementary to our operations. The completed acquisitions are and any subsequent acquisitions would be accompanied by the risks commonly encountered in such transactions. Such risks include, among other things:

- difficulties integrating the operations and personnel of acquired companies;
- the additional financial resources that may be needed to fund the operations of acquired companies;
- the potential disruption of our business;

- our management's ability to maximize **our** financial and strategic position by the incorporation of acquired technology or businesses into our service offerings;
- the **difficulty** of maintaining uniform standards, controls, procedures and policies;
- the potential loss of key employees of acquired companies;
- the impairment of relationships with employees and customers as a result of changes in management; and
- the **incurrence** of significant expenses in consummating acquisitions

Any of the above risks could prevent us **from** realizing significant **benefits from** our acquisitions. In addition, the issuance of our **common** stock in acquisitions will dilute our stockholder interests in **our company**, while the use of cash will deplete our cash reserves. Finally, if we are unable to account for our acquisitions under the "pooling of interests" method of accounting, we may incur significant, one-time write-offs and amortization charges. These write-offs and charges could decrease our **future** earnings or increase **our future** losses.

Our Future Success Depends Upon Third-Party Distribution and Engineering Relationships.

An important element of our strategy is to develop relationships with leading companies to enhance **our** distribution and engineering efforts. We have agreements with **Netscape** and Microsoft pursuant to which we distribute and modify their browsers. Our customization of browsers is an integral part of our current tailored VPN offerings. The **Netscape** agreement may be terminated at any time upon 60 days notice and the Microsoft agreement expires in March 1999. We are currently discussing with Microsoft an extension of the term of our agreement, but we cannot assure you that these discussions will be **successful**. We have an agreement with Intuit for the development, operation and maintenance of a VPN that is the integrated access, dial-up network and **infrastructure** used by purchasers of Quicken, Turbo Tax and other Intuit software products. **Intuit** customers use this VPN to access the Quicken Financial Network **Website** and the Internet. The **Intuit contract** may be terminated at the election of Intuit upon six months prior notice of an election to terminate. We have also recently entered into strategic **agreements** with SBC and **Teligent** for the delivery of private-labeled services to their customers. We rely on these relationships for the acquisition of enterprise and consumer customers. Our inability to capitalize on these agreements, the termination of or failure to renew any of these agreements or **our** inability to enter into similar relationships with others could have a material adverse effect on our business, **financial** condition and results of operation.

We have an outsourcing agreement with Williams Technology Solutions, a subsidiary of Williams Communications Group, Inc., that enables us to use Williams employees for the operational support of our network. Our use of Williams employees and Williams engineering expertise was integral to the development of our network and continue to be integral to the ongoing operation of our network operations center. Pursuant to the agreement with Williams, **all** of the Williams employees currently working for us will become our employees when the agreement terminates in December 2000. Termination of any of these agreements or our failure to renew any of the agreements upon termination on **terms** acceptable to us could have a material adverse effect on our business, **financial** condition and results of operations.

We Depend Upon New and Uncertain Markets.

We offer tailored, value-added network services for enterprises and consumers, including Internet access. These markets are in the early stages of development. It is **difficult** to predict the rate at which the market will grow, if at all, because these markets are relatively new and current and **future** competitors are likely to introduce competing services or products. New or increased competition may result in **market** saturation. Certain critical issues

concerning commercial use oftailored, value-added services and Internet services, remain unresolved and may impact the growth of such services. These issues include, among others, security, reliability, ease and cost of access, and quality of service. Our business, financial condition and results of operations would be materially adversely affected if the markets for our services, including Internet access:

- fail to grow;
- grow more slowly than anticipated; or
- become **saturated** with competitors.

We Depend Upon New and Enhanced Services.

We have recently introduced new enterprise service offerings, including the introduction of value-added, IP-based communication services to enterprises and a new line of DSL services in limited areas. The failure of these services to gain market acceptance in a timely manner or at all, or the failure of the DSL service in particular, to achieve **significant** market coverage could have a material adverse **effect** on our business, **financial** condition and results of operations. If we introduce new or enhanced services with reliability, quality or compatibility problems, then market acceptance of such services could be significantly delayed or hindered. Such problems or delays could adversely affect our ability to attract new customers and subscribers.

Our New or Enhanced Services May Have Errors or Defects.

Our services may contain undetected errors or defects when new services or enhancements are first introduced. We cannot assure you that, despite testing by us or our customers, errors will not be found in new services or enhancements **after** commencement of commercial deployment. Such errors could result in:

- additional development costs;
- loss of, or delays in, market acceptance;
- diversion of technical and other resources **from** our other development efforts; and
- the loss of customers and subscribers.

Any of these consequences could have a material adverse effect on our business, **financial** condition and results of operations.

We Need to Balance Network Use to Provide Quality Service.

If we do not achieve balanced network utilization over a 24-hour period, our network could become overburdened at certain periods during the day, which could adversely **affect** our quality of service. Conversely, due to the high **fixed** cost nature of our **infrastructure**, under-utilization of our network during certain periods of the day could adversely affect our ability to provide cost-efficient services at other times. Any failure to achieve balanced network utilization could have a material adverse effect on our business, financial condition and results of operations.

We Depend Upon Our Suppliers and Have Sole- and Limited-Sources of Supply for Certain Products and Services.

We rely on other companies to supply certain key **components of** our network **infrastructure**. These components include critical telecommunications services and networking equipment, which, in the quantities and quality demanded by us, are available **only from** sole- or limited-sources. AT&T Corp., MCI **WorldCom**, Inc., **PacWest Telecomm**, Inc. and Williams are our primary providers of data communications facilities and capacity. AT&T is currently the sole provider of the frame relay backbone of our network. MCI **WorldCom** and Williams are currently the providers of the ATM backbone of our network. We are also dependent upon **LECs** to provide telecommunications services to us and our customers. We experience delays **from** time to time in receiving telecommunications services from these suppliers. We cannot assure you that we will be able to obtain such services on the scale and within the time **frames** required by us at an **affordable** cost, or at all. Any failure to obtain such services on a **sufficient** scale, on a timely basis or at an affordable cost, would have a material adverse effect on our business, financial condition and **results** of operations.

We purchase our **Nortel/Bay**, Cisco Systems, Netopia, Lucent Technologies, Sun Microsystems and other vendor equipment either directly **from** the manufacturer or via systems integrators including Milgo Solutions, Inc. and Williams. Some of these vendors are sole-source suppliers. We purchase these components pursuant to purchase orders placed from time to time with our suppliers. We do not carry significant inventories of these components and have no guaranteed supply arrangements for such components. Our suppliers also sell products to our competitors and may in the future themselves become our competitors. We cannot assure you that our suppliers will not enter into exclusive **arrangements** with our competitors or stop selling their products or components to us at commercially reasonable prices, or at **all**.

The expansion of our network **infrastructure** is placing, and will continue to place, a significant demand on our suppliers. **Some** of these suppliers have limited resources and production capacity. In addition, some of our suppliers rely on sole-or limited-sources of supply for components included in their products. Failure of our suppliers to meet increasing demand may prevent them **from** continuing to supply components and products in the quantities and quality and at the times required by us, or at all. Our inability to obtain **sufficient** quantities of **sole-** or limited-source components or to develop alternative sources, if required, could result in delays and increased costs in expanding, and overburdening of, our network infrastructure. Any such delay, increased costs or overburdening would have a material adverse effect on our business, financial condition and results of operations.

We also depend on our suppliers' ability to provide **necessary** products and components that comply with various Internet and telecommunications standards. These products and components must also interoperate with products and components from other vendors. Any failure of our suppliers to provide products or components that comply with Internet standards or **that** interoperate with other products or components used by us in our **network** infrastructure could have a material adverse effect on our business, financial condition and results of operations.

Some **of** our suppliers, including the **RBOCs** and other **LECs**, currently are subject to **tariff** controls **and** other price constraints that in the future may be changed. In addition, regulatory proposals are pending that may **affect** what the **RBOCs** and other **LECs** charge us. Any such regulatory changes could result in increased prices of products and services, which could have a material adverse effect on our business, **financial** condition and results of operations.

We Depend Upon Our Network Infrastructure.

Our success depends upon the capacity, reliability and security of **our network infrastructure**. We currently derive a significant portion of our revenue from customer subscriptions. We expect that a substantial portion of our future revenue will be derived **from the** provision of tailored, value-added network services to our enterprise customers. We must continue to expand and adapt our network infrastructure as the number of users and the amount of information they wish to transfer increase and as customer requirements change. We currently project our network utilization will **require** rapid expansion of the network capacity to avoid capacity constraints that would adversely **affect** system performance. The expansion and adaptation of **our network infrastructure** will require substantial financial, operational and management resources in 1999 and future periods. We cannot assure you that we will **be** able to expand or adapt our network **infrastructure** to meet additional demand or our customers' changing

requirements on a timely basis, at a commercially reasonable cost, or at all. In addition, if demand for network usage were to increase faster than projected or were to exceed our current forecasts, the network could experience capacity constraints, which would adversely affect the performance of the system. Our business, financial condition and results of operations could be materially adversely affected if, for any reason, we fail to:

- expand our network infrastructure on a timely basis;
- adapt our network infrastructure to changing customer requirements or evolving industry trends; or
- alleviate capacity constraints experienced by our network infrastructure.

Currently, we have transit agreements with MCI WorldCom, Sprint and UUNet and we have peering agreements with America Online, PSINet and other network providers to support the exchange of traffic between our network and the Internet. We also have public peering arrangements with multiple smaller Internet service providers. These public peering arrangements also support the exchange of traffic between our network and the Internet. The failure of the networks with which we have public peering, private peering or private transit, or the failure of any of our data centers, or any other link in the delivery chain, or any inability to successfully integrate new network resources into our existing infrastructure, and resulting interruption of our operations would have a material adverse effect on our business, financial condition and results of operations.

Our Market Is Extremely Competitive.

The market for tailored value-added network services is extremely competitive. There are no substantial barriers to entry in this market, and we expect that competition will intensify in the future. We believe that our ability to compete successfully depends upon a number of factors, including:

- market presence;
- the capacity, reliability, low latency and security of our network infrastructure;
- technical expertise and functionality, performance and quality of services;
- customization;
- ease of access to and navigation of the Internet;
- the pricing policies of our competitors and suppliers;
- the variety of services;
- the timing of introductions of new services by us and our competitors;
- customer support;
- our ability to support industry standards; and
- industry and general economic trends.

Our competitors generally may be divided into four groups: telecommunications companies, online service providers, Internet service providers and Web hosting providers. Many of our competitors have greater market presence, engineering and marketing capabilities, and financial, technological and personnel resources than those available to us. As a result, they may be able to develop and expand their communications and network infrastructures more quickly, adapt more swiftly to new or emerging technologies and changes in customer

requirements, take advantage of acquisition and other opportunities more readily, and devote greater resources to the marketing and sale of their products and services than we can. In addition to the competitors discussed above, various organizations have entered into or are forming joint ventures or **consortiums** to provide services similar to those of our company.

We believe that new competitors will enter the value-added network services market. Such new competitors could include large computer hardware, software, media and other technology and telecommunications companies. Certain telecommunications companies and online services providers are currently offering or have announced plans to ~~offer~~ Internet or online services or to expand their network services. Certain companies, including America Online, BBN, **PSINet** and Verio, have also obtained or expanded their Internet access products and services as a result of acquisitions. Such acquisitions may permit our competitors to devote greater resources to the development and marketing of new competitive products and services and the marketing of existing competitive products and services. In addition, the ability of some of our competitors to bundle other services and products with **virtual** private network services or **Internet** access services could place us at a competitive disadvantage. Certain companies are also exploring the possibility of providing or are currently providing high-speed data services using alternative delivery methods such as over the cable television infrastructure, through direct broadcast satellites and over wireless cable.

As a result of increased competition and vertical and horizontal integration in the industry, we could encounter significant pricing pressure. This pricing pressure could result in significant reductions in the average selling price ~~of~~ our services. For example, telecommunications companies that compete with us may be able to provide **customers** with reduced communications costs in connection with their Internet access services or private network service?, reducing the overall cost of their solutions and significantly increasing price pressures on us. We cannot assure you that we will be able to offset the effects of any such price reductions with ~~an~~ increase in the number of our customers, higher revenue from enhanced services, cost reductions or otherwise. In addition, we believe that the Internet access and online services businesses are likely to encounter consolidation in the near future. Consolidation could result in increased price and other competition in these industries and, potentially, the virtual private networks industry. Increased price or other competition could result in erosion of our market share and could have a material adverse effect on our business, **financial** condition and results of operations. We cannot assure you that we will have the financial resources, technical expertise or marketing and support capabilities to continue to compete successfully.

We Must Keep Up With Rapid Technological Change and Evolving Industry Standards.

The markets for our services are characterized by rapidly changing technology, evolving industry standards, changes in customer needs, emerging competition and frequent new product and **service** introductions. Our **future** success will depend, in part, on our ability to:

- effectively use leading technologies;
- continue to develop our technical expertise;
- enhance our current networking services;
- develop new services that meet changing customer needs;
- advertise and market our services; and
- influence and respond to emerging industry standards and other technological changes,

All this must be accomplished in a timely and cost-effective manner. We cannot assure you that we will ~~be~~ successful in effectively using new technologies, developing new services or enhancing our existing services on a timely basis. We cannot assure you that such new technologies or enhancements will achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. We cannot assure you

that we will succeed in adapting our network service business to alternate access devices and conduits as they emerge.

We believe that our ability to compete successfully is also dependent upon the **continued** compatibility and **interoperability** of our services with products and architectures **offered** by various vendors. Although we intend to support emerging standards in the market for Internet access, we cannot assure you that **industry** standards will **be** established. If industry standards are established, we cannot assure you that we will be able to conform to these new standards in a timely fashion and maintain a competitive position in the market. Specifically, **our** services rely on the continued widespread commercial use of **TCP/IP**. Alternative open protocol and proprietary protocol standards have been or are being developed. If any of these alternative protocols become widely adopted, there may be a reduction in the use of **TCP/IP**, which could render our services obsolete and unmarketable. In addition, we cannot assure you that services or technologies developed by others will not render our services or technology uncompetitive or obsolete.

An integral part of our strategy is to design our network **to** meet the requirements of emerging standards such as 56.6 Kbps modems and applications such as IP-based interactive video and voice **conferencing** communications. **Our** initial deployment of 56.6 Kbps modem technology was difficult for some of our customers, including **WebTV**, due to compatibility problems between the software and their modems. We had to remove the software **from** the network and modems to **fix** the problem. We are currently testing a modified version of the **software** and we expect to redeploy it into the network in the **first** quarter of 1999. However, we cannot assure you that we will successfully redeploy the software. If we fail, for technological or other reasons, to develop and introduce the 56.6 Kbps modem technology or other new or enhanced services that are compatible with industry standards and that satisfy customer requirements, then our business, financial condition and results of operations would be materially adversely **affected**. See "Business-The Concentric Network."

We face the risk of fundamental changes in the way Internet access is delivered. Internet services are currently accessed primarily by computers connected by telephone lines. Several companies have announced the development and planned sale of cable television modems, wireless modems and satellite modems to provide Internet access. Cable **television**, satellite and wireless modems **can** transmit data at substantially faster speeds than the modems we and our subscribers currently use. In addition, wireless modems have the potential to reduce the cost of network services. As the Internet becomes accessible through these cable television, wireless and satellite modems and by screen-based telephones, televisions or other consumer electronic devices, or subscriber requirements change the way Internet access is provided, we will have to develop new technology or modify our existing technology to accommodate new developments such as:

- Internet access through cable television, satellite and wireless modems;
- Internet access through screen-based telephones, televisions or other consumer electronic devices; or
- subscriber requirements that change the way Internet access is provided

Our pursuit of these technological advances may require substantial time and expense. We cannot assure you that we will succeed in adapting our Internet access business to alternate access devices and conduits.

Our Network System Could Fail.

Network expansion and growth in usage will place increased stress upon our network hardware and **traffic** management systems. Our network has been designed with redundant backbone circuits to allow **traffic** re-routing. We cannot assure you, however, that we will not experience failures relating to individual network **POPs** or even catastrophic failure of the entire network. Moreover, our operations are dependent upon our ability to protect our network infrastructure against damage from power loss, telecommunications failures and similar events. A **significant** portion of our computer equipment, including critical equipment dedicated to our Internet access services, is located at our facilities in Chicago, Illinois, and Cupertino, California. In addition, our modems and routers that serve large

areas of the United States are located in these cities. Our network operations center, which manages the entire network, is in St. Louis, Missouri. Despite our precautions, a natural disaster, such as an earthquake, or other unanticipated problem at the network operations center, at one of our hubs (sites at which we have located routers, switches and other computer equipment that make up the backbone of our network **infrastructure**) or at a number of our **POPs** has from time to time in the past caused, and in the **future** could cause, **interruptions** in our services. In addition, our services could be interrupted if our telecommunications providers fail to provide the data communications capacity in the time frame required by us as a result of a natural disaster or for **some** other reason. Any damage or failure that causes interruptions in our operations could have a material adverse effect on our business, **financial** condition and results of operations.

Our System May Experience Security Breaches.

Despite the implementation of network security measures, the core of our **network** infrastructure is vulnerable to computer **viruses**, break-ins and similar disruptive problems **caused** by our **customers** or Internet users. Computer **viruses**, break-ins or other problems caused by third parties could lead to interruptions, delays or cessation in service to our customers and subscribers. **Furthermore**, inappropriate use of the network by third parties could also potentially jeopardize the security of confidential information stored in our computer systems and our customer's computer systems. We may face liability and may lose potential subscribers as a result. Although we intend to continue to implement **industry-standard** security measures, such measures occasionally have been circumvented in the past. We cannot assure you that our security enclosures will not be circumvented in the future. The costs and resources required to eliminate computer viruses and alleviate other security problems may result in **interruptions**, delays or cessation of service to our customers that could have a material adverse effect our business, financial condition and results of operations.

We Depend Upon Key Personnel and May be Unable to Timely Hire and Retain Sufficient Numbers of Qualified Personnel.

Our success depends to a significant degree upon the continued contributions of our executive management team, including Henry R. Nothhaft, the Company's Chairman, President and Chief Executive Officer, and John K. Peters, the Company's Executive Vice President and General Manager, Network Services Applications Division. The loss of the services of Mr. Nothhaft or Mr. Peters could have a material adverse effect on us. We do not have employment agreements with any of our senior officers, including Mr. Nothhaft or Mr. Peters. Nor do we **carry** key man life insurance on the life of any such persons. Our success will also depend upon the continued service of the other members of our senior management team and technical, marketing and sales personnel. Competition for qualified employees is intense. Our employees may voluntarily terminate their employment with us at any time. Our success also depends upon our ability to attract and retain additional highly qualified management, technical, sales and marketing and customer support personnel. Locating personnel with the combination of skills and attributes required to carry out our strategy is often a lengthy process. The loss of key personnel, or the inability to attract additional, qualified personnel, could have a material adverse effect upon our results of operations, development efforts and ability to complete the expansion of our network infrastructure. Any such event could have a material adverse effect on our business, financial condition and results of operations.

We Have Incurred Substantial Indebtedness and May Not Be Able to Service Our Debt.

We are and will continue to have a significant amount of outstanding indebtedness. We have significant debt service requirements as a result of this indebtedness. At December 31, 1998, our total debt (including current portion) was \$163.0 million and stockholders' deficit was \$56.9 million. Interest on such indebtedness totals approximately \$19.1 million per year. We also issued 150,000 shares of preferred stock in June 1998. Dividends accrue on the preferred stock at the rate of 13½% per year. At December 31, 1998, dividends and accretion on the **preferred** stock totaled approximately \$12.0 million. Dividends and accretion will total approximately \$23.0 million in 1999 and are expected to grow in each successive year. To date, we have chosen to pay such dividends in shares

of preferred stock, rather than in cash. We must also redeem the preferred stock in 2010. As a result of these and other features, the preferred stock is substantially equivalent to debt. Our debt, including the preferred stock, has important consequences for our company and for you, including the following:

- our ability to obtain additional financing in the future, whether for working capital, capital expenditures, acquisitions or other purposes, may be impaired;
- a substantial portion of our cash flow from operations is dedicated to the payment of interest on our debt, which reduces the funds available to us for other purposes;
- our flexibility in planning for or reacting to changes in market conditions may be limited; and
- we may be more vulnerable in the event of a downturn in our business.

Our ability to meet our debt service and preferred stock dividend obligations will depend on our future operating performance and financial results. This ability will be subject in part to factors beyond our control. Although we believe that our cash flow will be adequate to meet our interest and dividend payments, we cannot assure you that we will continue to generate sufficient cash flow in the future to meet our debt service and preferred stock requirements. If we are unable to generate cash flow in the future sufficient to cover our fixed charges and are unable to borrow sufficient funds from other sources, then we may be required to:

- refinance all or a portion of our existing debt; or
- sell all or a portion of our assets.

We cannot assure you that a refinancing would be possible. We cannot assure you that any asset sales would be timely or that the proceeds which we could realize from such asset sales would be sufficient to meet our debt service requirements. In addition, the terms of our debt and preferred stock restrict our ability to sell our assets and our use of the proceeds from any such asset sale.

We May Need Additional Capital in the Future and Such Additional Financing May Not Be Available.

We currently anticipate that our available cash resources, combined with the net proceeds from this offering and financing available under a network equipment lease agreement (that currently has no maximum borrowing limit), will be sufficient to meet our anticipated working capital and capital expenditure requirements through 1999. However, we cannot assure you that such resources will be sufficient for anticipated or unanticipated working capital and capital expenditure requirements. We may need to raise additional funds through public or private debt or equity financings in order to:

- take advantage of unanticipated opportunities, including more rapid international expansion or acquisitions of complementary businesses or technologies;
- develop new products or services; or
- respond to unanticipated competitive pressures.

We may also raise additional funds through public or private debt or equity financings if such financings become available on favorable terms. We cannot assure you that any additional financing we may need will be available on terms favorable to us, or at all. If adequate funds are not available or are not available on acceptable terms, we may not be able to take advantage of unanticipated opportunities, develop new products or services or otherwise respond to unanticipated competitive pressures. In such case, our business, results of operations and financial condition could be materially adversely affected. Our forecast of the period of time through which our financial resources will be adequate to support our operations is a forward looking statement that involves risks and

uncertainties, and **actual** results could vary materially as a result of a number of factors, including those set forth above.

We Face Risks Associated with International Expansion.

A key component of our strategy is to expand into international markets. The following risks are inherent in doing business on an international level:

- unexpected changes in regulatory requirements;
- **export** restrictions;
- export controls relating to encryption technology;
- tariffs and other trade barriers;
- difficulties in **staffing** and managing foreign operations;
- longer payment cycles;
- problems in collecting accounts receivable;
- political instability;
- fluctuations in currency exchange rates;
- seasonal reductions in business activity during the summer months in Europe and certain other parts of the world; and
- potentially adverse tax consequences that could adversely impact the success of our international operations.

We cannot assure you that one or more of such factors will not have a material adverse effect on our **future** international operations and, consequently, on our business, financial condition and **results** of operations.

We have an agreement with TMI Telemedia International, Ltd., a subsidiary of the leading Italian telecommunications company, Telecom Italia, SpA, to establish an international network based on our network technology and expertise and TMI's existing telecommunications **infrastructure**. In exchange, we granted TMI certain exclusive rights in critical markets, including Europe. While the goal of this **effort** is to deliver a range of compatible network services worldwide, to date we have had only limited deployment of services under this **agreement**. **Our** experience in working with TMI to develop versions of our products and to market and distribute our products internationally is limited. Our international strategy has not developed as rapidly as anticipated and may be further delayed if:

- we cannot **successfully** deploy our technology over TMI's infrastructure;
- we cannot transfer our knowledge to TMI's employees; or
- TMI does not devote sufficient management, technological or marketing resources to this project.

Our business, results of operation or **financial** condition could be materially adversely **affected** if delays in our international strategy continue or worsen.

We have entered into roaming **agreements** with third parties to allow our customers to access their Internet accounts **from** Japan and certain other **foreign** countries. We **provide** Web hosting and **extranet** services for GX Networks' United Kingdom customers pursuant to an agreement signed in August 1998. We also acquired Web hosting facilities in Stockholm, Sweden, Tokyo, Japan and Hong Kong in February 1998 as a result of our acquisition of **Internex**. We cannot assure you that we will be able to **successfully** market, sell and deliver our products in **these** markets.

Our Business May Be Impacted By The Year 2000 Issue.

The Year 2000 issue is the result of computer programs being written using two digits rather than four to **define** the applicable year. As a result, date-sensitive software may recognize a date using "00" as the year 1900 rather than the **year** 2000. This could result in system failures or miscalculations causing disruptions of normal business activities. We are currently in the process of reviewing **our** products and services, as well as our internal management information systems in order to identify and modify those products, services and systems that are not year 2000 compliant.

Based on our assessment to date, we have determined that our internally developed software, including much **of** our operational, financial and management information systems software, is year 2000 compliant. Our operational, financial and management information systems **software** which have not been internally developed have been certified as year 2000 compliant by the third party vendors who have supplied the software. To the extent that our systems **are** not year 2000 compliant, we are **modifying** such systems to make them compliant. We expect such modifications will be made on a timely basis and do not believe that the cost of such modifications will have a material effect on **our** operating results. Additionally, we are continuing to assess the year 2000 compliance of our products and services. To date, most of our newly introduced products and services do not contain material year 2000 deficiencies, however some of our customers are running earlier product versions that are not year 2000 compliant. We have been encouraging such customers to migrate to current product versions. We estimate that the capital and other costs associated with the upgrade and conversion of our existing products, services and systems relating to the year 2000 issue will not be material. We do not have and are not developing a contingency plan in the event our systems fail due to year 2000 related problems.

Our products, services and systems operate in complex network environments and directly, and indirectly interact with a number of other hardware and software systems. We face risks to the extent that suppliers of products, services and systems purchased by us and others with whom we transact business on a worldwide basis, including those which form significant portions of **our** network and may be sole- or limited-source suppliers, do not have business systems or products that comply with year 2000 requirements. We have not received any significant assurances from our **suppliers** that their networks are year 2000 compliant. **If** these networks fail, our business will be significantly impacted.

Our expectation that we will be able to upgrade our products, services and systems to address the year 2000 issue and our expectation regarding the costs associated with these upgrades are forward-looking statements subject to a number of risks and uncertainties. Actual results may vary materially as a result of a number of factors. We cannot assure you that we will be able to timely and **successfully** modify such products, services and systems to comply with year 2000 requirements. Any failure to do so could have a material adverse effect on our operating results. Furthermore, despite testing by us and our vendors, our products, services and systems may contain undetected errors or defects associated with year 2000 date functions. In the event any material **errors** or defects **are** not detected and fixed or third parties cannot timely provide us with products, services or systems that meet the year 2000 requirements, our operating results could be materially adversely affected. Known or unknown errors or defects that affect the operation of our products, services or systems could result in delay or loss of revenue, interruption of network services, cancellation of customer contracts, diversion of development resources, damage to our reputation, and litigation costs. We cannot assure you that these or other factors relating to year 2000 compliance issues will not have a material adverse effect on our business, operating results or financial condition.

We Could Face Government Regulation.

The Federal Communications Commission (“FCC”) currently does not regulate value-added network software or computer equipment related services that transport data or IP-based voice messages over telecommunication facilities as telecommunications services. We provide value-added IP-based network services, in part, through data transmissions over public telephone lines. Operators of these types of value-added networks that provide access to regulated transmission facilities only as part of a data services package are classified for regulatory purposes as providers of “information services” and are currently excluded from regulations that apply to “telecommunications carriers.” As such, we are not currently subject to direct regulation by the FCC or any other governmental agency, other than regulations applicable to businesses generally. However, future changes in law or regulation could result in some aspects of our current operations becoming subject to regulation by the FCC or another regulatory agency.

The FCC currently is reviewing its regulatory positions on data transmissions over telecommunications networks and could seek to impose some form of telecommunications carrier regulation on the network transport and telecommunications functions of an enhanced or information services package. Further, the FCC could conclude that our protocol conversions, computer processing and interaction with customer-supplied information are insufficient to afford us with the benefits of the enhanced or information service regulatory classification. If the FCC reaches such conclusions, it may seek to regulate some segments of our activities as telecommunications services.

State public utility commissions generally have declined to regulate enhanced or information services. Some states, however, have continued to regulate particular aspects of enhanced services in limited circumstances, such as where they are provided by incumbent LECs that operate telecommunications networks. Moreover, the public service commissions of some states continue to review potential regulation of such services. We cannot assure you that regulatory authorities of states where we provide Internet access, intranet and VPN services will not seek to regulate aspects of these activities as telecommunications services. The prices at which we may sell our services could be affected by regulatory changes:

- in the Internet connectivity market;
- that indirectly or directly affect telecommunications costs; or
- that increase the likelihood or scope of competition from the RBOCs

We cannot predict the impact, if any, that future regulation or regulatory changes may have on our business and we cannot assure you that future regulation or regulatory changes will not have a material adverse effect on our business, results of operations or financial condition.

We Depend On Our Proprietary Technology and Technological Expertise.

Our success and ability to compete is dependent in part upon our technology. In this regard, we believe our success is more dependent upon our technical expertise than our proprietary rights. We rely upon a combination of copyright, trademark and trade secret laws and contractual restrictions to protect our proprietary technology. It may be possible for a third party to copy or otherwise obtain and use our products or technology without authorization or to develop similar technology independently. We cannot assure you that such measures have been, or will be, adequate to protect our proprietary technology. Our competitors may also independently develop technologies that are substantially equivalent or superior to our technology.

We operate a material portion of our business over the Internet. The Internet is subject to a variety of risks. Such risks include but are not limited to the substantial uncertainties that exist regarding the system for assigning domain names and the status of private rules for resolution of disputes regarding rights to domain names. We cannot assure you that we will continue to be able to employ our current domain names in the future or that the loss of rights to one or more domain names will not have a material adverse effect on our business and results of operations.

Third Parties May Claim We Infringe Their Proprietary Rights.

Although we do not believe we **infringe** the proprietary rights of any third parties, we cannot assure you that third parties will not assert such claims against us in the future or that such claims will not be successful. We could incur substantial costs and diversion of management resources to defend any claims relating to proprietary rights, which could have a material adverse effect on our business, financial condition and results of operations. Furthermore, parties making such claims could **secure** a judgment awarding substantial damages, as well as injunctive or other equitable relief that could effectively block our ability to license our products in the United States or abroad. Such a judgment would have a material adverse effect on our business, **financial** condition and results of operations. In addition, we are obligated under certain agreements to indemnify **the** other party for claims that we **infringe** on the proprietary rights of third parties. If we are required to indemnify parties under these agreements, our business, **financial** condition and results of operations could be materially adversely affected. If someone asserts a claim relating to proprietary technology or information against us, we may seek licenses to such intellectual property. We cannot assure you, however, that we could obtain licenses on commercially reasonable terms, if at all. The failure to obtain the necessary licenses or other rights could have a material adverse **effect** on our **business**, financial condition and results of operations.

We Could Face Liability for Information Disseminated Through Our Network.

The law relating to the liability of online service providers, private network operators and Internet service providers for information carried on or disseminated through the facilities of their networks is continuing to evolve and remains unsettled. In the past, at least one court has ruled that Internet service providers could be found liable for copyright infringement as a result of information disseminated through their networks. Such claims have been asserted against us in the past and we cannot assure you that similar claims will not be asserted **in** the future. Federal laws have been enacted, however, which, under certain circumstances, provide Internet service providers with immunity from liability for information that is disseminated through their networks when they are acting as mere conduits & information. A Federal Court of Appeals has recently held that the Telecommunications Act of 1996 creates immunity **from** liability on the part of Internet service providers for libel claims arising out of information disseminated over their services by third party content providers. In addition, the Digital Millennium Copyright Act, which was enacted in 1998, creates a safe-harbor **from** copyright infringement liability for Internet service providers that meet certain requirements. These requirements include certain technical measures and registering with the Copyright Office the identity of the provider's Designated Infringement Agent who is to receive notice of any claims of copyright infringement. We cannot assure you, however, that the Digital Millennium Copyright Act or any other legislation will protect us from copyright infringement liability.

The Child Online Protection Act of 1998 prohibits and imposes criminal penalties and civil liability on anyone engaged in the business of selling or transferring, by means of the World Wide Web, material that is harmful to minors without restricting access to such material by persons under seventeen years of age. Numerous states have adopted or are currently considering similar types of legislation. The imposition upon us, Internet service providers or Web server hosts of potential liability **for such** materials carried on or disseminated through our systems could require us to implement measures to reduce our exposure to such liability. Such measures may require the expenditure **of** substantial **resources or** the discontinuation **of certain** product or service offerings. Further, the costs **of** defending against any such claims and potential adverse outcomes of such claims could have a material adverse effect on our business, financial condition and results of operations. The Child Online Protection Act of 1998 has been challenged by civil rights organizations in part on the grounds that it violates **the** First Amendment. A similar statute was held unconstitutional by the United States Supreme Court in 1997. A United States District Court **has** temporarily enjoined enforcement of the law until February 1, 1999, and it is possible that additional injunctions prohibiting enforcement **of the** statute will be entered pending **final** resolution **of the** case.

We Have Discretionary Authority Over the Use of Net Proceeds.

We have no specific allocations for the net proceeds of this offering. Consequently, management will retain a significant **amount** of discretion **over** the application of such proceeds. Because of the number and variability of factors that determine our use of the net proceeds of the offering, we cannot assure you that such applications will not vary substantially from our current intentions. Pending such uses, we intend to invest the net proceeds of the offering in short term U.S. investment grade and government securities.

Our Stock Price Has Been and May Continue to Be Volatile.

The trading price of our common stock has been and is likely to be highly volatile. Our stock price could be subject to wide fluctuations in response to a variety of factors, including the following:

- . actual or anticipated variations **in** quarterly operating results;
- . **announcements** of technological innovations;
- . new products or services offered by us or our competitors;
- . changes in financial estimates by securities analysts;
- . conditions or trends in the **network** services market;
- . our announcement of significant acquisitions, strategic partnerships, joint **ventures** or capital commitments;
- . additions or departures of key personnel;
- . sales of common stock; and
- . other events **or** factors that may be beyond **our** control,

In addition, the stock markets in general, and the Nasdaq National Market and the market for network services and technology companies in particular, have experienced extreme price and volume fluctuations recently. These fluctuations **often** have been unrelated or disproportionate to the operating **performance** of these companies. The trading prices of many technology companies' stocks are at or near historical highs and these trading prices and multiples are substantially above historical levels. These trading prices and multiples **may** not be sustained. These broad market and industry factors may materially adversely affect the market price of our common stock, regardless **of** our actual operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation often has been instituted against that company. Litigation like this, if instituted, could result in substantial costs and a diversion of management's attention and resources.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Stockholders of Concentric Network Corporation

We have audited the accompanying consolidated balance sheets of Concentric Network Corporation as of December 31, 1997 and 1998, and the related consolidated statements of operations, common stock subject to rescission and stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 1998. Our audits also included the financial statement schedule included in **Item 14**. These **financial** statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these **financial** statements and schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and **perform** the audit to obtain reasonable assurance about whether the financial statements are **free of** material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for **our** opinion.

In **our** opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of **Concentric Network** Corporation at December 31, 1997 and 1998, and the consolidated results of its operations and its cash flows for each of the **three** years in the period ended December 31, 1998, in **conformity** with generally accepted accounting principles. Also in our opinion, the related **financial** statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the financial information set forth therein.

/s/ ERNST & YOUNG LLP

San Jose, California
January 25, 1999, except for Note 15,
as to which the date is February 1, 1999